

Joint consultation conclusions on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong

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Glossary

AI	an authorized institution, as defined under the BO
AMB	a money broker approved under section 118C of the BO
ATS	automated trading services, as defined under the SFO
backloading	the reporting of transactions that were entered into prior to the triggering of the reporting obligation, but that were still outstanding at such time
BCBS	Basel Committee for Banking Supervision, whose secretariat is hosted by the Bank for International Settlements in Basel, Switzerland, that seeks to promote sound standards of banking supervision worldwide
BO	the Banking Ordinance (Chapter 155 of the Laws of Hong Kong)
CCP	a central counterparty, i.e. an institution that is interposed between two trading parties, becoming the buyer to every seller and the seller to every buyer
clearing eligible transactions	the specific types of OTC derivatives transactions determined by the HKMA and SFC as being subject to mandatory clearing (as discussed in paragraphs 56 to 58 of the Consultation Paper)
Conclusions Paper	this consultation conclusions paper
Consultation Paper	the consultation paper on the proposed regulatory regime for the OTC derivatives market jointly issued by the HKMA and SFC on 17 October 2011
CPSS	the Committee on Payment and Settlement Systems, a standard setting body for payment and securities settlement systems that also serves as a forum for central banks to monitor and analyse developments in domestic payment, clearing and settlement systems as well as in cross-border and multicurrency settlement schemes
EU	the European Union
G20 Leaders	the group of finance ministers and central bank governors from 20 major economies
HKMA	the Hong Kong Monetary Authority
HKMA-TR	the TR to be established and operated by the HKMA for the collection of data relating to OTC derivatives transactions
Hong Kong nexus	it was previously proposed that a transaction should be regarded as having a Hong Kong nexus if its underlying asset, currency or rate is (or includes one that is) denominated in or related to Hong Kong dollars, or in the case of credit or equity derivatives (if and when included), the underlying reference entity is established, incorporated or listed in Hong Kong or under Hong Kong law – see paragraph 71 of the Consultation Paper; but it is now proposed that this scope be narrowed as set out in paragraphs 105 to 112 of this Conclusions Paper

Hong Kong person	a person, other than an AI, LC or AMB, who operates from or has a connection with Hong Kong – see paragraphs 86 to 92 of this Conclusions Paper
IOSCO	the International Organization of Securities Commissions, an association of organisations that regulate the world's securities and futures markets
IRS	interest rate swaps, i.e. a derivatives transaction under which one counterparty exchanges a stream of interest payments for another counterparty's cash flow
LC	a licensed corporation, as defined under the SFO
NDF	non-deliverable forwards, i.e. a derivatives transaction under which the profit or loss at the time of settlement is calculated by reference to changes in the exchange rate between two currencies (i.e. changes between an agreed rate and the prevailing market rate at the time of settlement), and settled on a net basis in one currency
originated or executed	it was previously proposed that a transaction should be regarded "originated or executed" by a person if he has negotiated, arranged, confirmed or committed to the transaction on behalf of himself or any of the counterparties – see paragraph 64 of the Consultation Paper; but it is now proposed that this scope be narrowed as set out in paragraphs 115(2) to 116 of this Conclusions Paper
OTC derivatives transaction	a bilateral transaction where payment obligations are determined by reference to changes in the value or level of some underlying asset, rate, index, property, futures contract or by reference to the occurrence or non-occurrence of one or more events; and in connection with the proposed regime for Hong Kong, we propose to define this term as discussed in paragraphs 34 to 35 and 79 to 85 of this Conclusions Paper
overseas person	a person other than an AI, LC, AMB or Hong Kong person
RA / regulated activity	a regulated activity, as defined under the SFO – there are currently 10 RAs under the SFO, and it is proposed that two new RAs – Type 11 RA and Type 12 RA – be introduced for the purposes of the new OTC derivatives regime
RCH	a recognized clearing house, as defined under the SFO
REC	a recognized exchange company, as defined under the SFO
reportable transactions	the specific types of OTC derivatives transactions determined by the HKMA and SFC as being subject to mandatory reporting (as discussed in paragraphs 56 to 58 of the Consultation Paper)
SFC	the Securities and Futures Commission
SFO	the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong)
SIP / systemically important player	a person in Hong Kong who is not otherwise regulated by the HKMA or SFC but whose positions or activities in the OTC derivatives market

	may nevertheless raise concerns of potential systemic risk ¹
TR / trade repository	an entity that collects and maintains data relating to OTC derivatives transactions
Type 11 RA	the proposed new RA covering dealing in and advising on OTC derivatives transactions – see Section II of the supplemental consultation at Appendix 2 for more details
Type 12 RA	the proposed new RA covering the clearing and settlement of OTC derivatives transactions on behalf of another person – see Section III of the supplemental consultation at Appendix 2 for more details

¹ We had previously used the term “large players” to refer to participants in the OTC derivatives market who hold positions for their own account only, but whose positions raise concerns of potential systemic risk. However, on reflection, we consider that the term “systemically important players” may be a more appropriate term for such players as it more accurately reflects the types of players intended to be covered.

I. Introduction

1. On 17 October 2011, the Hong Kong Monetary Authority (**HKMA**) and Securities and Futures Commission (**SFC** or **Commission**) issued a joint consultation paper (**Consultation Paper**) on the proposed regulatory regime for the over-the-counter (**OTC**) derivatives market.
2. The paper set out the HKMA and SFC's then thinking on some of the key aspects of such a regime, and was put together with the benefit of prior discussions with market participants, and after taking into account developments in this area in the US, EU and other markets.
3. The deadline for submitting comments on the Consultation Paper was 30 November 2011. Some comments were submitted after the deadline but these were also considered.
4. We received a total of 34 written submissions from a range of respondents including banks, investment houses, market operators, industry bodies, law firms and professional bodies. A list of the respondents (other than those that requested to remain anonymous) is set out at **Appendix 1** and the full text of their comments (unless requested to be withheld from publication) can be viewed on the websites of the HKMA (www.hkma.gov.hk) and the SFC (www.sfc.hk).
5. This Conclusions Paper summarises the comments received, the HKMA and SFC's responses to these and our conclusions and proposals for taking the OTC derivatives reform initiative forward. This paper should be read together with the Consultation Paper and the comments received.
6. We take this opportunity to thank everyone who took the time and effort to comment on the proposals in our Consultation Paper. Your comments and suggestions have been most useful, and have helped us refine and finalise many key aspects of the new regime.

II. Executive summary

7. The global financial crisis of late 2008 highlighted the structural deficiencies in the OTC derivatives market, and the systemic risk it poses for the wider market and economy. In the wake of the crisis, G20 Leaders committed to reforms that would require –
 - (1) the mandatory reporting of OTC derivatives transactions to trade repositories (**TRs**),
 - (2) the mandatory clearing of standardised OTC derivatives transactions through central counterparties (**CCPs**),
 - (3) the mandatory trading of standardised OTC derivatives transactions on exchanges or electronic trading platforms, where appropriate, and
 - (4) the imposition of higher capital requirements in respect of OTC derivatives transactions that are not centrally cleared.

8. These requirements aim to reduce counterparty risk, improve overall transparency, protect against market abuse, and ultimately enable regulators to better assess, mitigate and manage systemic risk in the OTC derivatives market.
9. In line with this commitment, the HKMA and SFC consulted the market in October last year on a proposed regulatory regime for the OTC derivatives market in Hong Kong. This included proposals for the imposition of mandatory reporting, clearing and trading obligations, as well as proposals for the regulation of intermediaries and oversight of systemically important players (**SIPs**).¹
10. Respondents were generally supportive of the proposed regulatory regime and recognized the need for Hong Kong to develop and implement measures in line with the G20 Leaders' objectives of improving the OTC derivatives market. There were however concerns and questions about some of the more detailed aspects of the proposals.
11. In the paragraphs below, we summarise the main comments and concerns raised, our responses to these, and our revised position on the key aspects of the proposed regime. As will be seen, in view of the generally positive feedback from respondents, we are minded to proceed along the lines of our earlier proposals, albeit with some adjustments and refinements to address comments and concerns raised. We also propose to consult further on matters relating to the regulation of intermediaries and the oversight of SIPs. (A copy of our consultation on these matters is also attached at **Appendix 2** for ready reference.)
12. We would also note here that the details of the mandatory obligations, including their precise ambit, will be set out in subsidiary legislation, and we will be consulting on these separately in Q4 this year.

Main comments and concerns

13. We received a range of different and useful comments on the proposed regime. Many respondents also commented and made suggestions on some of the more detailed aspects and features of the regime. In brief however, the main comments and concerns raised were as follows.

Regulation of approved money brokers

14. There was concern that while the Consultation Paper specifically considered the role and position of authorized institutions (**AIs**) and licensed corporations (**LCs**), it did not specifically consider or discuss the position of inter-dealer brokers, and how they would fit into the new regime. Respondents noted that inter-dealer brokers were licensed and regulated by the HKMA as approved money brokers (**AMBs**) under the Banking Ordinance (**BO**), and in some instances also by the SFC as LCs.
15. We agree that the role of AMBs should be considered specifically given the fairly significant role they play in the OTC derivatives market. In view of the comments received, we consider that their OTC derivatives activities should be overseen and

¹ We had previously used the term "large players" to refer to participants in the OTC derivatives market who hold positions for their own account only, but whose positions raise concerns of potential systemic risk. However, on reflection, we consider that the term "systemically important players" may be a more appropriate term for such players as it more accurately reflects the types of players intended to be covered.

regulated by the HKMA rather than the SFC. Accordingly, they should not be required to be licensed for the new regulated activities (**RA**s) discussed in paragraphs 51 to 55 below (i.e. the new Type 11 or Type 12 RA). However, to the extent that their OTC derivatives activities also constitute an existing RA under the Securities and Futures Ordinance (**SFO**) they should continue to be licensed and regulated by the SFC as they are today.

16. We will accordingly adjust our original proposals to reflect the above. In particular, we will adjust our proposals regarding –
- (1) the division of regulatory responsibility (so that AMBs come primarily under the purview of the HKMA),
 - (2) the mandatory reporting and clearing obligations (so that AMBs' obligations are also set out specifically, and along similar lines as those of AIs and LCs), and
 - (3) the regulation of intermediaries (so that AMBs do not need to be licensed for the new Type 11 and Type 12 RAs).

Definition of “OTC derivatives transaction”

17. Another main concern raised by respondents relates to the definition of the term “OTC derivatives transaction”. The scope of this term is key as it will effectively delineate the ambit of the new OTC derivatives regime.
18. In the Consultation Paper, we proposed that the term “OTC derivatives transaction” should be defined by reference to the term “structured product” which already exists under the SFO, albeit with certain exclusions. However, many respondents felt that this still left the scope too wide. In particular, they urged that we also exclude all exchange-traded transactions, securitised products, embedded derivatives and spot contracts.
19. We generally agree, and will narrow the scope further to address these concerns – see paragraphs 34 to 35 below as well as paragraphs 79 to 85 below.

Extra-territorial impact

20. Many respondents raised concerns about the extra-territorial reach of the proposed mandatory reporting and mandatory clearing obligations. In particular, there was concern about extending these obligations in respect of transactions that are only “originated or executed” here, or that have a tenuous “Hong Kong nexus”. Respondents also generally felt that both concepts were too broad and vague, making it difficult for market players to ensure that they have fully complied with the mandatory obligations.
21. In view of the concerns raised, we will revise the mandatory clearing obligation so that it does not apply in respect of transactions that are merely “originated or executed” by players in our market – see paragraphs 40(3) and paragraphs 159 to 161 below. We will retain the “originated or executed” concept in relation to the mandatory reporting obligation to reflect the need to improve transparency. However, we propose to tighten its scope to provide better clarity – see paragraphs 113 to 120 below, and in particular paragraphs 115(2) and 116 below. Additionally, to reduce the extra-territorial impact, we will require transactions that are “originated or executed” here to be reported only if they also have a “Hong Kong nexus”. We also propose to tighten the scope of “Hong Kong nexus” to provide greater clarity – see paragraphs 105 to 112 below. We believe these

revisions should strike an appropriate balance between the industry's concerns about the scope of application and regulators' need for information for the purpose of effective market surveillance.

Confidentiality

22. Another concern raised in the context of the mandatory reporting obligation was that it may compel market players to breach confidentiality obligations under overseas laws. We agree that this is a valid concern. We will therefore try to build in a degree of flexibility into our regime so that the reporting obligation does not apply in situations where there is a conflicting confidentiality obligation under the laws of another jurisdiction, and such obligation cannot be overcome despite reasonable efforts – see paragraphs 124 to 126 below.

Location requirement for central counterparties (CCPs)

23. The Consultation Paper sought views on whether a location requirement should be imposed for products that are considered systemically important to Hong Kong such that they may only be cleared through a local CCP.
24. Apart from one respondent who strongly supported having a location requirement, most respondents strongly opposed this proposal. Generally, they felt that a location requirement was unnecessary, would fragment liquidity, break netting sets, increase costs and not necessarily decrease systemic risk.
25. Having considered the different views submitted, we do not propose to introduce a location requirement at this stage, but we will keep this issue under review as the OTC derivatives reforms evolve globally.

Regulation of market players

26. The Consultation Paper noted the need to regulate intermediaries who serve as dealers, advisers and clearing agents in the OTC derivatives market. To that end, we proposed to introduce a new RA to cover such intermediary activities, but noted that AIs would not need to be licensed for such new RA as their activities would remain under the HKMA's purview. We also proposed that the HKMA and SFC should have a degree of regulatory oversight in respect of SIPs,² i.e. Hong Kong players who are not otherwise regulated by the HKMA or SFC but whose positions or activities may nevertheless raise concerns of potential systemic risk.
27. Respondents generally agreed with the above approach but asked for more precise details on the ambit of the new RA, and the obligations of SIPs. Many respondents also put forward specific suggestions in this regard.
28. In view of the feedback received, we believe a more detailed proposal of the scope of any new RA should be exposed to the market for comment, as should our proposals for regulating SIPs. Accordingly, we will conduct a supplemental consultation on these matters, which consultation will be released at the same time as the release of this

² We had previously used the term "large players" to refer to participants in the OTC derivatives market who hold positions for their own account only, but whose positions raise concerns of potential systemic risk. However, on reflection, we consider that the term "systemically important players" may be a more appropriate term for such players as it more accurately reflects the types of players intended to be covered.

Conclusions Paper. (A copy of the supplemental consultation is also attached at **Appendix 2** for ready reference.)

Revised proposals

29. In light of the feedback received, we propose to revise some aspects of our earlier proposals. The paragraphs below summarise the key aspects of the proposed regime as revised.

Legislative framework and persons covered

30. As proposed in the Consultation Paper, the new OTC derivatives regulatory regime will be set out in the SFO, with the main obligations set out in the primary legislation and the details set out in the subsidiary legislation. A consultation paper on the details to be set out in subsidiary legislation is expected to be published in Q4 2012. This will elaborate on the detailed requirements under the new regime. (Paragraph 71 below highlights some of the main details that will be covered in the Q4 consultation.)
31. The new regime will provide for the introduction of mandatory obligations (i.e. mandatory reporting, clearing and trading, as appropriate), and the regulation and oversight of key players in the OTC derivatives market. The mandatory obligations will apply to AIs, LCs, AMBs and others who may be regarded as “Hong Kong persons”, and for this purpose, Hong Kong persons will include funds only if they are domiciled in Hong Kong.

Joint oversight by the HKMA and SFC

32. The new OTC derivatives regime will be jointly overseen and regulated by the HKMA and SFC, with the HKMA overseeing and regulating the OTC derivatives activities of AIs as well as AMBs, and the SFC overseeing and regulating the OTC derivatives activities of all other persons, including LCs.
33. To support the above, the HKMA will be given new powers under the SFO to investigate breaches of the mandatory obligations by AIs and AMBs, and to take disciplinary action against them for such breaches. We will also extend the SFC’s existing investigation powers under the SFO as necessary so that they cover breaches of the mandatory obligations by other persons, including LCs. The SFC’s disciplinary powers should not need expanding and will apply in respect of breaches by LCs only – see paragraph 190 below.

Scope of the new regime – “OTC derivatives transaction”

34. The term “OTC derivatives transaction” will be defined by reference to the term “structured product” (as defined in the SFO), but we will incorporate appropriate exclusions in respect of –
- (1) transactions in securities and futures contracts that are traded on a market operated by a recognized exchange company (**REC**), or on such other regulated markets as may be specified,
 - (2) transactions in structured products that are offered to the public and the documentation for which is authorized under section 105 of the SFO,

- (3) transactions in securitised products, embedded derivatives and similar products (i.e. products offered by a single issuer to a number of investors), and
- (4) spot contracts.

Additionally, and for flexibility, we will incorporate a power to enable specific transactions to be included within or excluded from the definition of “OTC derivatives transaction”.

- 35. The term “OTC derivatives transaction” will therefore still be defined fairly broadly. However, it does not follow that the mandatory obligations will be cast equally broad. This is because the mandatory obligations will only apply to the specific types of OTC derivatives transactions specified by the HKMA and SFC, and not to all OTC derivatives transactions.

Products to be subject to mandatory reporting and clearing

- 36. As proposed in the Consultation Paper, the HKMA and SFC will jointly determine the specific types of OTC derivatives transactions to be mandated for reporting or clearing, and will do so only after public consultation. The transactions mandated for reporting (**reportable transactions**) may differ from those mandated for clearing (**clearing eligible transactions**), although there may be some overlap between the two (i.e. some transactions may be mandated for both reporting and clearing). In any event, the mandatory reporting and clearing obligations will initially only cover certain types of interest rate swaps (**IRS**) and non-deliverable forwards (**NDF**), although this will subsequently be extended, in phases, to cover other types of transactions and products. Any such extension will also be subject to public consultation before implementation.

Mandatory reporting obligation

- 37. We remain of the view that in order for Hong Kong regulators to obtain relevant OTC derivatives information effectively, only one trade repository (**TR**), i.e. the one to be established by the HKMA (**HKMA-TR**), should be designated for the purposes of the mandatory reporting obligation. In other words, reporting to global TRs will not suffice for the purposes of any mandatory reporting obligation under Hong Kong law. However, we will monitor international development with respect to TRs and keep this matter under review.
- 38. As for the specifics of the mandatory reporting obligation, we propose that these be revised as follows –
 - (1) The reporting obligation for Hong Kong persons will remain unchanged, i.e. their reportable transactions will have to be reported if their positions exceed a specified threshold (**reporting threshold**), which will be assessed based on the total amount of gross positions held. AMBs will not be regarded as Hong Kong persons for this purpose. Instead, they will be treated in the same way as AIs and LCs in that their reporting obligation will not be subject to any reporting threshold.
 - (2) For LCs, AMBs and locally-incorporated AIs, the reporting obligation will apply if –
 - (a) they are a counterparty to the transaction, or

- (b) they have originated or executed the transaction, and the transaction has a Hong Kong nexus.³
- (3) For overseas-incorporated AIs, the reporting obligation will apply if the AI, acting through its Hong Kong branch, has –
 - (a) become a counterparty to the transaction,⁴ or
 - (b) originated or executed the transaction, and the transaction has a Hong Kong nexus.⁵

In other words, the mandatory reporting obligation will not apply to an overseas-incorporated AI if –

- (i) its Hong Kong branch is neither involved as a counterparty to, nor as an originator or executor of, the reportable transaction, or
- (ii) its Hong Kong branch is the originator or executor of the transaction, but the reportable transaction does not have a Hong Kong nexus.
- (4) We will also refine and tighten the concepts of “originated or executed” and “Hong Kong nexus” to provide greater clarity and reduce their extra-territorial reach – see paragraphs 105 to 112 below (for details on “Hong Kong nexus”) and paragraphs 113 to 120 below (for details on “originated or executed”). A key effect of the proposed changes to the concept of “originated or executed” is that the mandatory reporting obligation will not apply to persons such as AMBs whose activities are limited to conducting pure broking in OTC derivatives for unrelated customers.
- (5) Additionally, and to reduce the compliance burden –
 - (a) An AI, LC or AMB that has originated or executed a reportable transaction which has a Hong Kong nexus will be taken to have discharged its reporting obligation in respect of that transaction if the counterparty on whose behalf it was acting has confirmed to the AI, LC or AMB that the transaction has been reported to the HKMA-TR.
 - (b) Similarly, Hong Kong persons who have exceeded the reporting threshold will be exempted from having to report a transaction if it involves an AI, LC or AMB and the latter has an obligation to report it. However, as the reporting obligation of AIs, LCs and AMBs will be narrowed (as a result of the changes described in sub-paragraphs (2) to (4) above), it follows that the exemption granted to Hong Kong persons will be correspondingly narrowed as well.

³ Previously, we did not propose that transactions originated or executed by locally-incorporated AIs, LCs or AMBs should also have a Hong Kong nexus.

⁴ Meaning the transaction is booked in the Hong Kong branch according to accounting record.

⁵ Previously, we proposed that all reportable transactions originated or executed by the Hong Kong branch of an overseas AI should be reported, and the requirement for a Hong Kong nexus was only relevant in respect of transactions to which the overseas-incorporated AI was a counterparty but not through its Hong Kong branch.

- (6) For the purposes of effective supervision of a local banking group, a locally-incorporated AI may be required to procure that any one or more of its subsidiaries (as specified by the HKMA) report their OTC derivatives transactions to the HKMA-TR. The obligation to ensure that the subsidiaries report the relevant transactions to the HKMA-TR will however remain with the AI, meaning the AI will be liable if it fails to procure its subsidiaries to report. For avoidance of doubt, any such reporting will be on an individual transaction basis, and reportable transactions of the AI and each of the specified subsidiaries in the banking group should be reported to the HKMA-TR separately.

More details on the specifics of the mandatory reporting obligation, including details on the various matters discussed in sub-paragraphs (1) to (6) above, will be provided when we consult on the detailed requirements in Q4 this year. Meanwhile, **Appendix 3** shows a flow chart that summarises when the mandatory reporting obligation will be triggered under the revised proposal.

39. We also take this opportunity to clarify our proposals on a few further matters –

- (1) Reportable transactions that are centrally cleared: Where it is intended that a reportable transaction will also be centrally cleared, the person reporting the transaction to the HKMA-TR must also: (i) report the fact that the transaction is anticipated to be cleared at a CCP, (ii) provide certain further information about the clearing arrangements as may be reasonably required, and (iii) keep the HKMA-TR updated on any subsequent changes arising from life cycle events as if the original transaction had not been centrally cleared. Moreover, where the transaction is novated by the CCP, the CCP will not be required to report the novated transactions, nor any subsequent changes arising from life cycle events.
- (2) Breach of confidentiality obligations under overseas laws: We will build in a degree of flexibility to allow for situations where a transaction cannot be reported due to conflicting legal obligations under overseas laws which cannot be overcome despite reasonable efforts.
- (3) Exemptions for central banks, etc: In terms of exemptions from mandatory reporting, we are prepared to consider extending such exemptions to: (i) central banks, (ii) monetary authorities or public bodies charged with responsibility for the management of public debt and reserves and the maintenance of market stability, as well as (iii) certain global institutions such as the International Monetary Fund, the Bank for International Settlements, etc. Criteria such as reciprocity will be taken into account when determining whether to grant exemption for central banks, monetary authorities and public bodies.
- (4) Use and disclosure of data collected: We also take this opportunity to clarify that data collected by the HKMA-TR will be used solely for regulatory and market surveillance purposes, and that any public disclosure of such data will initially be on an aggregate basis only. The HKMA-TR will also strive to adhere to international standards on sharing data with overseas regulators, authorities and TRs. The secrecy and disclosure provisions under the SFO will be amended accordingly.
- (5) Legal entity identifiers (LEIs): Before a globally agreed LEI regime is available, an interim solution will have to be introduced to facilitate the reporting of

counterparty identity to the HKMA-TR. The interim solution will include options that should not have significant cost implications for reporting entities.

Again, more details on each of the matters discussed in sub-paragraphs (1) to (5) above will be provided when we consult on the detailed requirements in Q4 this year.

Mandatory clearing obligation

40. On the specifics of the mandatory clearing obligation, we propose to revise these as follows –

- (1) AIs, LCs, AMBs and Hong Kong persons that are counterparty to a clearing eligible transaction will be required to clear such transaction through a designated CCP if –
 - (a) both they and their counterparty have exceeded a specified threshold (**clearing threshold**), which will be assessed based on the total amount of gross positions held by the entities, and
 - (b) their counterparty is not exempted from the clearing obligation (see sub-paragraph (5) below which discusses possible exemptions).
- (2) Where one of the counterparties (the first party) has not exceeded the clearing threshold, or is exempted from the clearing obligation, the transaction will not be subject to mandatory clearing, and it will suffice for the other counterparty to rely on a declaration from the first party confirming that it has not reached the clearing threshold or is exempted from the clearing obligation.
- (3) We will remove the previously proposed “originated or executed” limb. In other words, the clearing obligation will not arise only by virtue of an AI, LC or AMB having “originated or executed” a clearing eligible transaction. Effectively therefore, the mandatory clearing obligation will apply equally to AIs, LCs, AMBs and Hong Kong persons, i.e. in each case, they must be a counterparty to the transaction. Additionally, in the case of an overseas-incorporated AI, the mandatory clearing obligation will only apply if the clearing eligible transaction is booked in the Hong Kong branch of the AI according to the accounting record.
- (4) For the purposes of effective supervision of a local banking group, a locally-incorporated AI may be expected to procure that any one or more of its subsidiaries (as specified by the HKMA) comply with the clearing requirement, if the aggregate OTC derivatives positions of the AI and such specified subsidiaries exceed the clearing threshold. The obligation to ensure that the specified subsidiaries clear their OTC derivatives transactions will however remain with the AI, meaning the AI will be liable if it fails to procure the specified subsidiaries to clear their transactions. The AI and the specified subsidiaries in the banking group should each submit their relevant transactions to central clearing separately.
- (5) In terms of exemptions from mandatory clearing, we are prepared to consider extending these in respect of transactions with: (i) central banks, (ii) monetary authorities or public bodies charged with the management of public debt and reserves and the maintenance of market stability, as well as (iii) global institutions such as the International Monetary Fund, the Bank for International

Settlements, etc. As with mandatory reporting, criteria such as reciprocity will be taken into account when determining whether to grant exemption for central banks, monetary authorities and public bodies. We are also prepared to consider extending exemptions in respect of non-financial entities using OTC derivatives for commercial hedging purposes, intra-group transactions and transactions involving “closed markets”.⁶

More details on the specifics of the mandatory clearing obligation, including details on the various matters discussed in sub-paragraphs (1) to (5) above, will be provided when we consult on the detailed requirements in Q4 this year. Meanwhile, **Appendix 4** shows a flow chart that summarises when the mandatory clearing obligation will be triggered under the revised proposal.

Mandatory trading obligation

41. As proposed in the Consultation Paper, we will not impose a mandatory trading requirement at the outset. Instead, we will first conduct further study to assess how best to implement such a requirement in Hong Kong.

Penalties for breach

42. As proposed in the Consultation Paper, fines will be imposed for breach of the mandatory obligations and these will be set at levels comparable to those set in major jurisdictions elsewhere. We will also take into account fine levels set for other breaches of reporting obligations under the SFO. To that end, we will seek to introduce new provisions in the SFO that allow the Court of First Instance to impose civil fines of up to a specified amount on any person who breaches the mandatory obligations.
43. Additionally, where breaches are by AIs, AMBs or LCs, we also intend that regulators should be able to take disciplinary action against them. To that end, we will seek to expand the existing disciplinary regime under Part IX of the SFO as appropriate.
44. Separately, we note the concerns raised by some respondents that breaches of the mandatory obligations should not affect the validity and enforceability of transactions entered into by market participants. We will consider how best to address these in the legislation. Further details on this will be provided when we consult on the subsidiary legislation in Q4 this year.

Regulation of CCPs

45. As proposed in the Consultation Paper, both local and overseas CCPs may become designated CCPs for the purposes of the mandatory clearing obligation. However, as a

⁶ “Closed markets” refer to jurisdictions which have a material level of foreign exchange control, and/or other local regulatory restrictions that make it impractical to require clearing to take place in any jurisdiction other than its own jurisdiction. Such a jurisdiction is also likely to require relevant OTC derivatives transactions to be cleared through a CCP located in that jurisdiction, even though such CCP may not be able to meet internationally recognized requirements and standards. As a result, the laws of such jurisdictions may conflict with any mandatory obligation imposed under Hong Kong law. That said, where a CCP in a “closed market” jurisdiction can be recognized under Hong Kong laws and designated for the purposes of mandatory clearing in Hong Kong, no such conflict should arise (since clearing through such a CCP would comply with Hong Kong law as well).

pre-requisite to such designation, they will first need to be either a recognized clearing house (**RCH**) or an authorized automated trading services (**ATS**) provider.

46. When assessing the suitability of a CCP to be designated, we will refer to international standards, including those set by standard setting bodies such as the CPSS and IOSCO.
47. We do not propose to introduce a location requirement for designated CCPs at this stage. However, we will keep this issue under review as the new OTC reforms evolve and are implemented globally.
48. As noted in the Consultation Paper, we intend to facilitate indirect clearing. To that end, we agree that amendments may be needed to ensure that the insolvency override provisions under the SFO are appropriately extended. We are however still studying the specific changes that should be made and will provide further information on our thinking on this issue when we consult on the subsidiary legislation later this year.
49. Lastly, we do intend to allow local CCPs to be able to accept overseas clearing members (i.e. remote members), but only if such members' clearing activities are regulated under the laws of an "acceptable overseas jurisdiction" – see paragraph 208 below for details on what constitutes an "acceptable overseas jurisdiction" for these purposes.

Capital and margin requirements

50. As proposed in the Consultation Paper, we intend to impose higher capital requirements and margin requirements for non-cleared OTC derivatives transactions. However, specific proposals on this will be put forward for consultation after IOSCO and BCBS have jointly issued their final proposal on margin requirements, and the BCBS has finalised its guidance on the relevant capital requirements for banks. The HKMA will also separately consult the banking and deposit-taking industry associations on any relevant guidance issued by the BCBS.

Regulation of intermediaries

51. As proposed in the Consultation Paper, we intend to regulate persons who serve as intermediaries in the OTC derivatives market. To that end, it will be necessary to introduce two new RAs: (i) a new Type 11 RA which will capture the activities of dealers and advisers, and (ii) a new Type 12 RA which will capture the activities of clearing agents. It will also be necessary to expand the existing Type 9 RA (asset management) to cover the management of portfolios of OTC derivatives.
52. The scope of the two new RAs, and the expanded Type 9 RA, will need to include a number of carve-outs, including carve-outs to address overlaps with existing RAs. Our specific proposals in this regard are set out in a separate supplemental consultation paper which will be issued at the same time as the release of this Conclusions Paper. A copy of this supplemental consultation is also attached at **Appendix 2** for ready reference.
53. We also propose to introduce transitional arrangements for the new RAs and expanded Type 9 RA so as to minimise disruption to market players' current OTC derivatives activities. Our specific proposals in this regard are also set out in the supplemental consultation paper mentioned above.

54. AIs and AMBs will not have to be licensed (or registered) for the new Type 11 or Type 12 RA, and their activities as OTC derivatives dealers, advisers and clearing agents will instead be overseen by the HKMA. However, to the extent that an AI or AMB's OTC derivatives activities overlap with any existing RA, or with the expanded Type 9 RA, the AI or AMB will still need to be licensed (or registered) for such existing RA or the expanded Type 9 RA. This too is discussed in the supplemental consultation at Appendix 2.
55. In any event, the HKMA and SFC will work together to ensure that regulatory requirements applicable to AIs, LCs and AMBs are aligned and consistently applied so as to maintain a level playing field among different market players.

Oversight of systemically important players (SIPs)

56. As proposed in the Consultation Paper, we intend to have a degree of regulatory oversight in respect of SIPs, i.e. players in Hong Kong who are not already regulated but whose positions and activities may raise concerns of potential systemic risk.
57. To that end, we propose to require market players to notify the SFC if their OTC derivatives positions exceed a certain threshold (which threshold will be many times higher than both the reporting and clearing thresholds). We also propose that their names and details of their positions should then be entered in a register of SIPs to be kept and maintained by the SFC. Information in the register of SIPs would be shared with the HKMA, but we are still considering whether names of SIPs entered in the register should be disclosed to the public.
58. We also propose that regulators have power to require SIPs to –
- (1) provide such information regarding their OTC derivatives activities and transactions as may be specified, and
 - (2) take certain action in respect of their positions and any collateral provided or collected as may be specified – although this power should only be exercised if regulators have reasonable cause to believe that the SIP's activities or transactions in the OTC derivatives market pose systemic risk to the financial markets in Hong Kong.

Additionally, SIPs who fail to provide information, or to take action as specified, should be subject to disciplinary action by the SFC.

59. Our specific proposals for regulating SIPs are also set out in the supplemental consultation paper at Appendix 2, and we welcome views on these from interested parties.

Other matters

Establishment of the HKMA-TR

60. As mentioned in the Consultation Paper, the HKMA is in the process of establishing a local TR (i.e. the HKMA-TR) for the collection of data relating to OTC derivatives transactions and for supporting central clearing of OTC derivatives at any local CCP that may be established. Work is progressing and it is currently expected that the HKMA-TR will be launched in two stages – the first in Q4 this year to support any local CCP that

may be established by then, and then in 2013 to support mandatory reporting when implemented.

Establishment of a local CCP

61. As mentioned in the Consultation Paper, Hong Kong Exchanges and Clearing Limited (**HKEx**) is in the process of establishing a new clearing house in Hong Kong that can serve as a CCP for the OTC derivatives market here. Work is progressing and, subject to it being authorized as an RCH, HKEx plans to start operations in clearing certain IRS and NDF in Q4 this year.

Interim legislative amendment

62. The current legislation does not expressly support central clearing of OTC derivatives transactions through an RCH. In particular, the existing insolvency override provisions under Part III of the SFO only apply in respect of securities and futures contracts. Hence, even if OTC derivatives transactions are cleared through an RCH, they will not enjoy the protection of these override provisions (unless they also constitute either securities or futures contracts).
63. This gap will be rectified under the new regime. However, as it will take some time to complete the legislative process for this, we have taken steps to put in place a temporary solution. Specifically, the Securities and Futures (Futures Contracts) Notice 2012, made pursuant to section 392 of the SFO (**Section 392 Notice**), was tabled before the Legislative Council on 9 May 2012 for negative vetting, and came into effect on 27 June 2012. The Section 392 Notice effectively deems OTC derivatives transactions to be futures contracts for certain limited purposes. The overall effect is to extend the insolvency override provisions under Part III of the SFO so that they also cover OTC derivatives transactions that are cleared and novated through an RCH and subject to the rules of an REC.
64. The Section 392 Notice will be repealed and superseded when the new regime for OTC derivatives comes into effect.

Concluding thoughts and next steps

65. The issue of this paper marks a key milestone in Hong Kong's efforts to reform and regulate the OTC derivatives market in line with other major jurisdictions.
66. As a next step, we will be conducting two further consultations – the first will be on the scope of the new RAs and expanded Type 9 RA, as well as the regulation of SIPs; the second will be on the subsidiary legislation that will set out the detailed requirements under the new regime. Separately, we will also be working with the Government on the drafting of amendments to primary legislation, with a view to introducing the relevant Bill into the Legislative Council in Q4 2012.
67. As work on building the new regime continues, we intend to continue maintaining a close and regular dialogue with the industry. We therefore continue to welcome views and discussion with interested parties.

III. Comments received and our response

A. The broad framework

Legislative framework

68. We proposed in the Consultation Paper that the new OTC derivatives regime should be set out in the SFO, with the mandatory reporting, clearing and trading obligations set out in broad terms in the primary legislation and the details set out in the subsidiary legislation. This proposed approach will give regulators the flexibility to introduce changes as needed, and in a timely manner, to keep in step with market developments and evolving global regulatory standards and practices.
69. Respondents were generally supportive of this approach and the reasons for it. We also received various suggestions on the types of details that should be included in the primary legislation. It was also noted that a clear timeframe for legislation and implementation should be provided to market participants.
70. We welcome the strong support for the proposed approach and will proceed with developing the detailed rules for further consultation accordingly. We also recognize the importance of providing clarity and certainty to market participants on the scope and application of the new regime. We will continue to maintain a close dialogue with the industry to keep it informed of developments.
71. We target to publish a consultation paper on the subsidiary legislation in Q4 2012, which will provide market participants with further information on the proposed detailed requirements of the new regime. Among other things, the Q4 consultation will elaborate on the precise ambit of the mandatory obligations, including matters such as –
- (1) definitions of some of the key concepts delineating the mandatory obligations (e.g. “originated or executed”, “Hong Kong nexus”, and “Hong Kong person”),
 - (2) which specific types of transactions will be subject to the mandatory obligations,
 - (3) who will be subject to the mandatory obligations, and in what circumstances,
 - (4) what the reporting and clearing thresholds will be, and the circumstances in which they will apply,
 - (5) which types of persons and transactions may be exempted from the mandatory obligations,
 - (6) what information will have to be included when reporting a transaction to the HKMA-TR, and
 - (7) details relating to grace periods, backloading, etc.

Joint oversight by the HKMA and SFC and the position of inter-dealer brokers

72. We proposed in the Consultation Paper that the new regime should be jointly overseen and regulated by the HKMA and SFC, with the HKMA overseeing and regulating the OTC derivatives activities of AIs and the SFC overseeing and regulating the OTC

derivatives activities of LCs and other persons. Appropriate amendments to the SFO were also proposed to be introduced to reflect the joint oversight by the HKMA and SFC.

Position of inter-dealer brokers / AMBs

73. Most respondents supported the proposed division of regulatory responsibility between the HKMA and SFC. However, there was concern that the position of inter-dealer brokers had not been specifically considered and clearly stated in the Consultation Paper, and clarification was sought in this regard.
74. The key function of inter-dealer brokers in the OTC derivatives market is to facilitate transactions between counterparties rather than to take on positions as principal themselves. We note also that these players are today largely regulated by the HKMA as AMBs under the BO, and that the SFC only oversees them to a limited extent (i.e. if their activities also constitute an RA under the SFO).
75. In view of the above, we consider that AMBs' OTC derivatives activities should be overseen and regulated by the HKMA rather than the SFC. However, to the extent that their OTC derivatives activities also constitute an existing RA, AMBs will still need to be licensed and regulated by the SFC. We also consider that we should specifically set out how the mandatory obligations apply to AMBs, and along similar lines as for AIs and LCs).
76. The licensing obligations of AMBs (vis-à-vis their OTC derivatives activities) are discussed in more detail in paragraphs 237 to 243 below. As for how the mandatory reporting and clearing obligations will apply to AMBs, this is discussed in more detail in paragraphs 113 to 120 below (for mandatory reporting) and paragraphs 158 and 161 below (for mandatory clearing).

Need for clear division and level playing field

77. A few market participants also noted the importance of having a clear division of responsibility between the two regulators, and ensuring there would be no regulatory overlap between them. Additionally, it was suggested that further consultation should be undertaken on the proposed supervisory arrangements, and that the HKMA and SFC should consider reviewing the existing Memorandum of Understanding (**MoU**) to determine whether any amendment is necessary in order to reflect the proposed division of responsibility.
78. We agree that it is necessary to have clarity on the division of regulatory responsibility. To that end, the HKMA will need to be given specific powers under the SFO to investigate any breach of the mandatory obligations by AIs and AMBs, and to take disciplinary action against them in the event of such breach. We also intend to put in place an MoU that covers the HKMA and SFC's regulatory oversight of the OTC derivatives market, as that will also be critical to providing clarity. The MoU will also help achieve a unified approach so that regulatory requirements imposed on AIs, LCs and AMBs are aligned and consistently applied so as to maintain a level playing field among different market players.

Scope of the new regime – “OTC derivatives transaction”

79. The term “OTC derivatives transaction” will have to be carefully defined as it will effectively delineate the ambit of the new regulatory regime. In the Consultation Paper,

we proposed to define this term by reference to the SFO definition of “structured product”⁷, but to exclude the following –

- (1) transactions in securities and futures contracts that are traded on a recognized market (i.e. a market operated by an REC),
- (2) transactions in structured products that are offered to the public and the documentation for which is authorized under section 105 of the SFO, and
- (3) transactions in currency-linked instruments, interest rate-linked instruments or currency and interest rate-linked instruments offered by AIs to the public and the documentation for which is exempted from the prohibition under section 103(1) of the SFO by virtue of section 103(3)(ea) of the SFO.

80. To cater for market development in products, we also proposed in the Consultation Paper to include a power in the SFO that will allow specific transactions to be expressly included within, or excluded from, the ambit of “OTC derivatives transaction”.

81. The industry raised a number of concerns about this approach, and noted the potentially over-expansive reach and lack of clarity that it could create. Several respondents strongly advocated incorporating additional carve-outs for derivatives traded on an REC, securities and futures contracts traded on overseas exchanges, securitised products and embedded derivatives. The need for clarification on the position of spot contracts was also noted. Apart from suggestions on specific carve-outs, we also received alternative proposals for drafting the definition – for example, tracking the relevant definitions used in the Banking (Capital) Rules with appropriate amendments, and adopting an independent definition that captures bilateral OTC derivatives transactions.

82. We appreciate and agree that it is important to have a clear definition for “OTC derivatives transaction” in the legislation. We also appreciate and understand many of the concerns raised. However, having considered the comments submitted, we remain of the view that defining “OTC derivatives transaction” by reference to “structured product” is the better option given that: (i) the latter is cast widely enough to capture the full range of products that are intended, and (ii) introducing a new term in the SFO that overlaps with an existing one has the potential for greater confusion.

83. That said, we agree that apart from those transactions mentioned in paragraphs 79 and 80 above, the scope of the term “OTC derivatives transaction” should also exclude –

- (1) securities and futures contracts traded on overseas exchanges and markets (although this should be limited to exchanges and markets that meet certain specified criteria),
- (2) securitised products, embedded derivatives and similar products (i.e. products offered by a single issuer to a number of investors), and
- (3) spot contracts.

⁷ The term “structured product” was introduced under the Securities and Futures and Companies Legislation (Structured Products Amendment) Ordinance 2011.

84. Ultimately the objective is to only capture transactions that are derivative in nature, and that are negotiated and entered into on a bilateral basis (as opposed to transactions that are offered on a “one-to-many” basis), and that are not already regulated under existing laws and regulations. We will accordingly incorporate appropriate carve-outs for these. A point to note here is that with the exclusion of embedded derivatives, it is no longer necessary to have a separate carve-out as per paragraph 79(3) above. This is because the transactions captured by the latter are essentially embedded derivatives.
85. In view of the above, it follows that the term “OTC derivatives transaction” will therefore still be defined fairly broadly. However, this does not mean that the mandatory obligations will apply equally widely. This is because the mandatory obligations will only apply to specific types of OTC derivatives transactions as are specified by the HKMA and SFC, and not to all OTC derivatives transactions.

Definition of “Hong Kong persons”

86. The Consultation Paper proposed that the scope of the new regime should not only cover AIs and LCs, but also other persons who operate from Hong Kong, or have a connection with Hong Kong (referred to in the Consultation Paper as “Hong Kong persons”).
87. We proposed in the Consultation Paper that the term “Hong Kong persons” should refer to the following –
- (1) individuals who are Hong Kong residents;
 - (2) the owners of any sole proprietorship or partnership that is based in, operated from, or registered in Hong Kong;
 - (3) companies that are incorporated or registered in Hong Kong;
 - (4) funds that are managed in or from Hong Kong (irrespective of whether they are established as a company or a trust); and
 - (5) any other entity that is established or registered under Hong Kong law.
88. A few respondents commented on this issue. In particular, they noted that the definition should be based on objectively ascertainable standards that draw upon existing statutory definitions and requirements, and that the use of terms such as “based in”, “operated from”, and “managed in or from” should be avoided. We note these concerns and will keep them in view when drafting the specific provisions.
89. Respondents also sought clarification on the scope of funds that will fall within the proposed definition of “Hong Kong persons”. In particular, they asked whether a sub-fund of a SICAV⁸ that is managed in Hong Kong (or its SICAV vehicle) will be regarded as a “Hong Kong person”.
90. In light of the comments received, we have reconsidered the extent to which funds should be regarded as “Hong Kong persons”. We now propose that only those funds that

⁸ An SICAV is an open-ended collective investment scheme common in Western Europe. It can be translated in English as an “investment company with variable capital”.

are domiciled in Hong Kong (i.e. established under Hong Kong law) should be regarded as “Hong Kong persons”.

91. This narrower approach will not compromise our ability to obtain information about OTC derivatives transactions with a Hong Kong nexus and entered into by funds managed in or from Hong Kong. This is because, as will be seen later (see paragraphs 240 to 243 below), we intend to expand the scope of Type 9 RA (asset management) so that it covers the management of OTC derivatives portfolios. This means that for OTC derivatives funds that are managed from Hong Kong, the fund manager will need to be licensed for Type 9 RA. It will therefore be an LC, and subject to the mandatory reporting obligation as an LC. That will include reporting transactions that are originated or executed by it on behalf of the fund, and that have a Hong Kong nexus (see paragraphs 113 to 120 below).
92. For completeness, we also note that the term “Hong Kong persons” will no longer include AMBs. This is because, as mentioned in paragraph 16 above, we consider that the mandatory obligations of AMBs should be set out specifically, and along similar lines as for AIs and LCs.

B. Products to be subject to mandatory reporting and clearing

93. In the Consultation Paper, we proposed that the mandatory reporting and clearing obligations should only apply in respect of certain specified OTC derivatives transactions – referred to respectively as “reportable transactions” and “clearing eligible transactions”.
94. As to which transactions should be specified, and how, we proposed that –
 - (1) the HKMA and SFC should jointly determine the list of reportable transactions and clearing eligible transactions, and that this should be done after market consultation,
 - (2) only certain types of IRS and NDF should be specified initially but this should be subsequently extended, in phases, to cover other interest rate and foreign exchange derivatives, as well as other asset classes such as credit and equity derivatives,
 - (3) additionally, reportable transactions should at the outset be limited to transactions in single currency IRS, overnight index swaps, single currency basis swaps and NDF,
 - (4) when determining the list of clearing eligible transactions, both a top-down and bottom-up approach should be adopted, i.e. taking into consideration what regulators consider as products suitable for central clearing as well as products proposed by designated CCPs for central clearing.
95. Respondents agreed with this proposed phased approach but emphasised the need to conduct market consultation when extending the mandatory obligations to new product classes. A few respondents also suggested introducing a different basis for phasing, for example, phasing by entity or by standardisation of product classes.
96. There was also general support for the proposal to initially limit the scope of any mandatory reporting and clearing obligations so that they only apply in respect of certain

IRS and NDF. With regard to the product coverage in subsequent phases, one respondent emphasised the need for caution when extending the mandatory obligations to equity derivatives. Another respondent considered that there may not be a sufficient degree of standardisation in the documentation used for the majority of equity derivatives transactions to allow for the introduction of mandatory clearing in the near term.

97. Additionally, respondents suggested that regulators consider issuing a policy framework describing the circumstances under which the product coverage will be expanded and setting up a committee comprising regulators, CCPs and market participants to determine what transactions should be designated as clearing eligible.
98. Respondents also generally supported the use of a balanced combination of both a top-down and bottom-up approach in determining what products should be mandated for clearing. Some also suggested taking into account factors, such as the availability of an appropriate infrastructure framework for clearing, the effect on the mitigation of systemic risk, the costs of submitting the products to clearing, the existence of substantial notional exposure, liquidity and adequate pricing data, when assessing product suitability for the mandatory clearing requirement.
99. In view of the above, we consider it appropriate to adopt the proposed phased approach and initial scope for the mandatory obligations. We believe that this will provide the necessary flexibility for implementing the new mandatory reporting and clearing requirements, taking into account the specific circumstances of our local market. We appreciate the various comments provided by respondents and will consider them carefully when assessing product suitability for the purposes of the mandatory obligations.
100. We would also emphasise here that the list of reportable transactions and the list of clearing eligible transactions are expected to be set out in subsidiary legislation, and that (in line with section 398 of the SFO) the HKMA and SFC will conduct public consultation before introducing any changes to these.⁹ This would also be in line with IOSCO's February 2012 report on Requirements for Mandatory Clearing, which (among other things) recommends that regulators should consult the public when introducing products for mandatory clearing.

C. Proposed mandatory reporting obligation

Global vs local TR

101. We proposed in the Consultation Paper that where the mandatory reporting obligation applies, the relevant transactions should be reported to the HKMA-TR. Several respondents advocated the recognition and use of global TRs to fulfil the reporting obligation. They noted that this would reduce the compliance burden that would otherwise result from having to report to multiple TRs and comply with different reporting standards and requirements. Some respondents also noted that if a local TR is considered necessary, then its implementation plans (including its implementation schedule) should be synchronised with the development of global TRs.

⁹ Section 398 of the SFO generally requires the SFC to conduct public consultation before making any subsidiary legislation. This section will also apply in respect of subsidiary legislation made in relation to the OTC derivatives regime. This means the duty to consult will be enshrined in legislation.

102. We appreciate the concerns expressed. However, in order to ensure that Hong Kong regulators can obtain relevant OTC derivatives information as quickly and directly as possible, we remain of the view that we should designate only one TR, i.e. the HKMA-TR, for the purposes of the mandatory reporting obligation. This is particularly crucial given that global TRs will be located outside Hong Kong and subject to overseas laws, and that these laws may prevent or limit them from sharing data with regulators in Hong Kong. However, we will monitor international developments with respect to TRs and keep this matter under review.
103. In any event, we would emphasise that we intend to allow market players to appoint a third party for the purposes of the reporting obligation – see paragraphs 131 to 132 below. This means they can, for example, report transactions via a global TR. This should help reduce the compliance burden to a certain extent. Additionally, the HKMA-TR will strive to adopt international standards and practices on reporting requirements. This should help address concerns about market players being subject to different reporting requirements in different jurisdictions.

Position of AMBs

104. As mentioned earlier, the Consultation Paper did not specifically discuss the position of AMBs. We take this opportunity to clarify that AMBs will be subject to the mandatory reporting obligation along similar lines as AIs and LCs. That said, we note that the business model of AMBs does not typically involve taking proprietary positions, but rather focuses on pure broking for unrelated customers. Hence in practice, the mandatory reporting obligation may likely have little impact on them.

Hong Kong nexus

105. We introduced the concept of “Hong Kong nexus” in the Consultation Paper to define the reporting obligation of an overseas-incorporated AI. Specifically, we proposed that an overseas-incorporated AI should report a reportable transaction if: (i) it has become a counterparty to the transaction through its Hong Kong branch, (ii) it has originated or executed the transaction through its Hong Kong branch, or (iii) the transaction has a Hong Kong nexus and the AI has become a counterparty to it, albeit not through its Hong Kong branch.
106. We also proposed that Hong Kong nexus should mean the following –
- (1) in the case of equity derivatives and credit derivatives, that the underlying entity or the reference entity is established, incorporated or listed in Hong Kong or under Hong Kong law, and
 - (2) in the case of other derivatives, that the underlying asset, currency or rate is denominated in or related to (or includes an asset, currency or rate that is denominated in or related to) Hong Kong dollars.
107. Some respondents considered that the proposed concept of Hong Kong nexus was too broad and expressed concerns about its extra-territorial reach. In particular, there was concern that the concept could create compliance problems as the Hong Kong branch of an overseas-incorporated AI may not be able to ensure that all transactions that have a Hong Kong nexus and that are handled by either its head office or other overseas branches are reported to the HKMA-TR – particularly if the Hong Kong branch is not involved at all. Respondents therefore urged regulators to reconsider this issue.

Separately, one respondent suggested that if the Hong Kong nexus concept were to be retained, it should catch only relevant transactions (e.g. for equity derivatives, they should be caught only if their underlying are Hong Kong listed shares, and not if their underlying are merely shares of a Hong Kong incorporated company).

108. We appreciate and acknowledge the compliance difficulty noted by respondents. In view of this, we will narrow the reporting obligation of overseas-incorporated AIs so that it only applies where: (i) the AI has become a counterparty to a reportable transaction through its Hong Kong branch, or (ii) the AI has originated or executed a reportable transaction through its Hong Kong branch and the transaction has a Hong Kong nexus. In other words –

- (1) The original proposal to require reporting where the Hong Kong branch has become a counterparty to the transaction will remain.
- (2) The original proposal to require reporting where the Hong Kong branch has originated or executed the transaction will be tightened by adding a requirement for the transaction to have a Hong Kong nexus. (The concept of “originated or executed” itself will also be tightened – this is discussed in paragraphs 113 to 120 below.)
- (3) The original proposal to require reporting where the Hong Kong branch is not involved at all will be removed.

109. Additionally, the definition of Hong Kong nexus will be fine-tuned to mean –

- (1) in the case of equity derivatives and credit derivatives,
 - (a) that the underlying entity or the reference entity is listed in Hong Kong, and where there is more than one underlying entity or reference entity, a specified percentage of the entities (and this may be by value or otherwise) are listed in Hong Kong, or
 - (b) that the underlying is an index and a specified percentage of the underlying companies (and again, this may be by value or otherwise) are listed in Hong Kong, or
 - (c) that the reference entity is, or is wholly owned by, the Government of the Hong Kong Special Administrative Region, and
- (2) in the case of other derivatives, that the underlying asset, currency or rate is denominated in or related to (or includes an asset, currency or rate that is denominated in or related to) Hong Kong dollars or Renminbi.

110. As to what the specified percentage (mentioned in paragraphs 109(1)(a) and 109(1)(b) above) should be, we are still considering possible options, and will provide more details when we consult on the detailed requirements in Q4 this year.

111. As for the reference to Renminbi in paragraph 109(2) above, since Hong Kong is a major offshore Renminbi business centre and many financial institutions are active in conducting Renminbi deliverable and non-deliverable derivatives transactions, there is a need for us to monitor financial institutions’ exposures to these transactions as well as any systemic risk that such transactions in aggregate might pose. Therefore, we consider it necessary to include Renminbi in the scope of “Hong Kong nexus”.

112. In any event, we will keep the concept of “Hong Kong nexus” under review, and amend it as necessary going forward.

Origination and execution

113. We proposed in the Consultation Paper that LCs and AIs should be required to report all reportable transactions that they have originated or executed even though they may not be counterparties to the transactions. A number of respondents advocated the removal of this requirement, citing different reasons –

- (1) Some felt the definition of “originated or executed”, as proposed, would make the mandatory reporting obligation too wide and uncertain, and thus make compliance difficult.
- (2) Some noted that the requirement may replicate the obligation imposed by overseas regulators without bringing the benefits of reduced systemic risk.
- (3) It was also noted that the requirement was not supported by international practice.

114. We believe that transactions originated or executed here may have implications for the monetary and financial stability of Hong Kong. Therefore we have a need to capture them under our mandatory reporting regime. That said, we consider that –

- (1) there is room to narrow down the scope of “originate or execute” and give it greater clarity, and
- (2) the concept of “Hong Kong nexus” can be incorporated in this regard to further limit the range of transactions that need to be reported under the “originated or executed” limb.

115. Accordingly, we propose to revise our original proposal such that a reportable transaction that is “originated or executed” by a locally-incorporated AI, the Hong Kong branch of an overseas-incorporated AI, an LC or an AMB will have to be reported to the HKMA-TR but only if it also has a Hong Kong nexus, and for this purpose –

- (1) “Hong Kong nexus” will take on the more limited scope discussed in paragraphs 105 to 112 above, and
- (2) an AI, LC or AMB will only be regarded as having “originated or executed” an OTC derivatives transaction if –
 - (a) it has agreed with the counterparty the normal economic terms of the transaction, either directly or through an intermediary, and
 - (b) a “related party”, rather than the AI or LC itself, has been designated to be the final contracting party to the transaction.

116. For this purpose, a related party will include –

- (1) in respect of an AI or LC, any company within the same group as the AI or LC ,

- (2) in the event that the OTC derivatives transaction is originated or executed by an overseas-incorporated AI acting through its Hong Kong branch, its head office and any overseas branch of the AI, and
 - (3) any entity on whose behalf the AI, LC or AMB has full discretion and authority to agree the terms of the transaction.
117. We believe the qualifications in paragraphs 116(1) and 116(2) above are necessary in light of the current practice of investment banks in Hong Kong, whereby the transaction is typically negotiated in Hong Kong but booked overseas. We do not consider it necessary to cover AMBs here, given that their business model does not involve taking a proprietary position.
118. As for the qualification in paragraph 116(3) above, this is intended to cover situations where the AI, LC or AMB has full control over the counterparty that has entered into the transaction, i.e. the AI, LC or AMB should report such transactions. A typical example would be a fund manager that negotiates a transaction on behalf of a fund that it manages.
119. It follows that the concept of “originated or executed” should not include the act of pure broking of OTC derivatives transactions for unrelated customers, which we understand is the typical business model of AMBs.
120. For completeness, we note that an AI, LC or AMB that has originated or executed a reportable transaction which has a Hong Kong nexus, will be taken to have discharged its reporting obligation in respect of that transaction if the counterparty on whose behalf it originated or executed the transaction confirms that it has reported the transaction to the HKMA-TR. This is similar to what was proposed in the Consultation Paper except that it will apply to AMBs as well.

Impact on reporting obligation of Hong Kong persons

121. The reporting obligation of Hong Kong persons will remain unchanged, i.e. their reportable transactions will only have to be reported if their positions exceed the reporting threshold, which will be assessed based on the total amount of gross positions held. Additionally, Hong Kong persons who have exceeded the reporting threshold will be exempted from the reporting obligation if their transactions involve an AI, LC or AMB that has an obligation to report such transactions.
122. However, as the reporting obligation of AIs, LCs and AMBs will be reduced (as a result of the narrowing of the “originated or executed” and “Hong Kong nexus” concepts as discussed in paragraphs 105 to 120 above), it follows that the exemption granted to Hong Kong persons will also be reduced correspondingly. Hence, for example, if a Hong Kong person is a counterparty to a transaction, and that transaction –
- (1) is only originated or executed by an AI, LC or AMB (i.e. no AI, LC or AMB is counterparty to it), and
 - (2) does not have a Hong Kong nexus,

then the Hong Kong person will be required to report that transaction. This is because the transaction will not be reportable by the AI, LC or AMB. Consequently, the Hong Kong person cannot be exempted from reporting.

123. While we appreciate the impact that the revised proposal will have on Hong Kong persons, we believe this is unavoidable given that these transactions are undertaken by Hong Kong persons and it is necessary for regulators to be able to monitor the exposure of Hong Kong persons to certain OTC derivatives products, bearing in mind that such persons will have to report only if the gross amount of exposures exceeds the reporting threshold. Moreover, a Hong Kong person can still be relieved from the reporting obligation if its counterparty is an AI, LC or AMB which has to report the trade to the HKMA-TR. On the other hand, even if its counterparty is an AI, LC or AMB which does not have to report the trade to the HKMA-TR (e.g. because the transaction is originated here but does not have a Hong Kong nexus), the Hong Kong person may nevertheless, on a mutually agreed basis, appoint that counterparty (i.e. the AI, LC or AMB) as its agent to discharge its reporting obligation. In practice, if an AI, LC or AMB is involved in a reportable transaction with a Hong Kong person, but is not required to report the transaction to the HKMA-TR (e.g. because the AI, LC or AMB has only originated or executed the transaction but the transaction has no Hong Kong nexus), we would expect the AI, LC or AMB to inform the Hong Kong person of this fact in advance so that the latter may assess what implications this has on its reporting obligation.

Confidentiality, breach of overseas laws, and exemptions for central banks, etc

124. Another concern raised in connection with the extra-territorial impact of the proposed mandatory reporting obligation was the potential breach of confidentiality obligations under overseas laws.
125. Specifically, some respondents pointed out that in certain locations where Hong Kong-incorporated AIs operate through branches or subsidiaries, local regulators may impose client confidentiality and bank secrecy obligations, which may prevent the provision of information to the HKMA-TR. Similarly, the Hong Kong branches of overseas-incorporated AIs may in any event have to comply with their home country reporting obligations, and the drafting of local rules should take this into consideration. Separately, respondents also queried whether different reporting obligations should apply in respect of “sensitive” transactions – e.g. where the AI or LC’s counterparty was a central bank, state foreign exchange manager or sovereign wealth fund.
126. We agree that the concern about conflict of laws is a valid one. It has always been our policy intent that an AI, AMB or LC should comply with all applicable laws at all times. Accordingly, we propose that the reporting obligation should not apply in respect of transactions booked outside Hong Kong if the reporting of such transaction to the HKMA-TR will infringe any applicable legislation or regulation in the jurisdiction where the transaction is booked, and reasonable efforts to avoid such infringement have been unsuccessful. Hence –
- (1) Where such legislation or regulation requires a reporting entity located outside Hong Kong to obtain explicit customer consent before it can transfer customer information abroad, including to the HKMA-TR, we will expect the reporting entity to make reasonable efforts to obtain the customer’s consent.
 - (2) Additionally, if a positive consent cannot be obtained, or if the customer cannot be reached or does not respond, the reporting entity should assess whether it is legally permissible to report the transaction to the HKMA-TR with the customer’s identity masked. If even reporting on this basis is prohibited by local law, then the reporting obligation will not apply.

More details in this regard will be provided when we consult on the detailed requirements in Q4 this year.

127. With respect to exemptions for central banks, etc, we have considered regulations proposed in other financial centres. In view of these, we are prepared to consider incorporating limited exemptions in respect of public sector entities involved in the management of public debt from the mandatory reporting obligation in order to avoid affecting their powers to stabilise the market, as and when required. These include central banks, monetary authorities or public bodies charged with the management of public debt and reserves and the maintenance of market stability, as well as global institutions such as the International Monetary Fund, the Bank for International Settlements, etc. Specifically, our current thinking is that –

- (1) all such global institutions should be exempted in full from the reporting obligation ,
- (2) for central banks, authorities and bodies, criteria such as reciprocity will be taken into account when determining whether to grant reporting exemptions.

However, in each case, the counterparty would not be exempted from the reporting obligation.

128. More details regarding possible exemptions will be provided when we consult on the detailed requirements in Q4 this year. We will also continue to monitor international standards and practices to determine whether we should exempt other categories of persons from the mandatory reporting requirement.

Reporting for the purpose of consolidated supervision

129. We proposed in the Consultation Paper that the HKMA may require a locally-incorporated AI to not only report its own positions but also to ensure that the positions of any one or more of its subsidiaries (as the HKMA may specify) are reported.

130. Some respondents objected to a banking group having to report positions on a consolidated basis. However, that is not the intention. (Indeed, we believe some confusion in this regard may have arisen because of our use of the word “positions” rather than “transactions” in this context.) We take this opportunity to clarify as follows –

- (1) We are not proposing that a locally-incorporated AI should report the positions or transactions of all of its branches and subsidiaries, or do so on an aggregate basis. Rather, we propose that the HKMA may require a locally-incorporated AI to procure that one or more of its subsidiaries (as specified by the HKMA) comply with the mandatory reporting requirement. This is intended to prevent the AI from circumventing the mandatory reporting obligation by spreading its positions or transactions into different subsidiaries and then ensuring that each subsidiary also stays below the reporting threshold and thus escapes from the reporting obligation. Such spreading of positions or transactions could effectively shield them from regulatory surveillance, and thus defeat the objective of the mandatory reporting obligation.
- (2) Where subsidiaries are specified, the locally-incorporated AI will be expected to procure each of the specified subsidiaries to report their reportable transactions to the HKMA-TR separately (regardless of whether the subsidiaries’ own

reporting obligation has been triggered), rather than the AI reporting its own reportable transactions together with those of the specified subsidiaries on an aggregate basis. This obligation of the AI to procure reporting of transactions by the specified subsidiaries is however distinct from each subsidiary's own reporting obligation which will only be triggered if its positions exceed the reporting threshold.

- (3) The HKMA's specification of subsidiaries for this purpose will be determined on a case-by-case basis having regard to the specific circumstances of individual locally-incorporated AIs.

Agency reporting

131. We received general support for the proposal to permit the use of reporting agents. However, respondents also requested that appropriate protection be given to institutions that use reporting agents, so that they are only liable for breaches arising from their own actions.
132. The concern is noted and we will consider how best to incorporate appropriate safeguards when drafting the legislation. Further details in this regard will be provided when we consult on the detailed requirements in Q4 this year.

Use of TR data and public disclosure

133. Some respondents highlighted the importance of protecting the confidentiality of data collected by the HKMA-TR, and emphasised that the data should be used solely for regulatory purposes. There were also suggestions to establish procedures to ensure that foreign regulators accessing the data are acting clearly within the scope of their regulatory authority.
134. Some respondents also stressed that any public disclosure of trade data should be in a manner that protects market liquidity, confidentiality of participants and their ability to hedge their exposure arising from the transaction. It was also suggested that any public disclosure should allow for a sufficient time lag so that: (i) the market participants involved have sufficient time to properly hedge themselves in the market, and (ii) other participants that operate on multi-leg trades cannot take advantage of the disclosure.
135. We acknowledge the comments and concerns raised. We confirm that data collected by the HKMA-TR will be used solely for regulatory and market surveillance purposes. We also confirm that any disclosure of such data to the public will initially be on an aggregate basis only. The HKMA-TR will also strive to adhere to international standards when sharing data with overseas regulators. In this regard, the secrecy and disclosure provisions under the SFO will be expanded as necessary to cover the data collected by the HKMA-TR, and provide for any sharing of such data with authorities and regulators in Hong Kong and overseas, as well as with overseas TRs. Any sharing of data with overseas authorities and regulators will be subject to safeguards similar to those currently in place. Likewise, any sharing of data with overseas TR will be permitted only if the overseas TR is subject to adequate supervision by its home regulator, and operated in accordance with internationally recognized principles and standards.
136. We would also note here that both the HKMA and SFC are members of the CPSS-IOSCO Working Group on Authorities' access to TR data. We are therefore closely

involved in setting the international standards for data access and use, and will endeavour to ensure that our laws and regulations comply with these.

Reporting threshold

137. In the Consultation Paper, we proposed to set the reporting threshold on a per product class basis. We also proposed to refer to the average notional value of a person's outstanding positions for the previous six months based on his month-end position when assessing if the reporting threshold has been exceeded. To reduce the compliance burden and avoid the effect of temporary fluctuations, we also proposed to provide an exit threshold, which would be set at a lower level than the reporting threshold.
138. Most respondents generally supported the proposal of setting a reporting threshold, although a few opposed it. We also received some suggestions on the methodology for setting the threshold, including the following –
- (1) The threshold should apply on a net basis.
 - (2) Care should be taken not to define the product classes in an overly granular manner.
 - (3) Legal title and beneficial interest are not always the same. The threshold should be calculated in different manner for different types of entities.
 - (4) Set different thresholds for different types of transactions and counterparties.
 - (5) Set the threshold on transaction basis.
 - (6) There should be a sundry category for certain complex derivatives transactions that may not fall within the product classes.
 - (7) The gap between the exit threshold and reporting threshold should be sufficiently wide.
139. We welcome the general support for the reporting threshold, which is intended to ease the compliance burden of non-financial firms (i.e. entities other than AIs, LCs and AMBs). With respect to the suggestion noted in paragraph 138(1) above, we remain of the view that the threshold should be applied against gross positions for the sake of simplicity. We would also note that the threshold setting methodology should only have impact on entities other than AIs, LCs or AMBs. Also, such entities will be relieved of the reporting obligation if they transact with, or through, an AI, LC or AMB that has a reporting obligation in respect of the same transaction. (This is because persons other than AIs, AMBs and LCs will not be required to report transactions to which they are counterparty if the transaction is in any event reportable by an AI, AMB or LC.)
140. In response to the suggestion noted in paragraphs 138(2) and 138(7) above, we confirm that we do not intend to define the product classes in an overly granular basis, and that we will ensure that the gap between the reporting threshold and exit threshold is appropriately wide. As regards the various other suggestions noted in paragraph 138 above, we are not minded to adopt these at this stage as they may make the threshold calculation too complicated.
141. Lastly, in response to a query from one respondent, we would clarify that we are currently minded to treat NDF as a separate asset class from FX derivatives for the

purposes of calculating the threshold. More information on thresholds, and their operation, will be provided when we consult on the detailed requirements in Q4 this year.

Delayed reporting / exemption

142. Some respondents suggested that delayed reporting for large-sized/block trades and exemption for overseas-incorporated AIs from reporting older/pre-dated trades should be allowed.
143. The suggestion on delayed reporting for large/block trades appears to stem from the concern that transactional data may be released to the public on a real-time basis. To alleviate this concern, we clarify that we are not proposing to introduce real-time reporting under our regime, and certainly not at the outset. Moreover, data collected by the HKMA-TR will initially be disclosed to the public on an aggregate basis only. We also do not propose to exempt overseas-incorporated AIs from the reporting of older/pre-dated trades in order to keep the regulatory regime simple and to avoid creating an unlevel playing field as between overseas-incorporated AIs and other intermediaries (i.e. locally-incorporated AIs, LCs and AMBs).

Duplicate reporting

144. In the Consultation Paper, we proposed that the reporting obligation should apply to each counterparty to an OTC derivatives transaction. Some respondents suggested that we should only require transactions to be reported by one counterparty.
145. We understand that one-side reporting can help reduce the reporting burden. However, requiring both counterparties to report will allow the HKMA-TR to perform better data quality checks. There should also be no concern about double-counting as the HKMA-TR has the system capability to prevent this. We would also add here that we have tried to reduce the reporting burden where possible. In particular, for persons other than AIs, LCs and AMBs, their reportable transactions will not have to be reported if they are reportable by an AI, LC or AMB.

Reporting timeframe

146. A few respondents expressed concern about the proposed “T+1” reporting timeframe, citing that it may be too short and challenging to meet.
147. We understand that the “T+1” reporting timeframe is in line with international practice. However, in view of the concerns raised, and given certain technical issues arising from reporting by overseas entities in a later time zone, we propose to extend the reporting timeframe to “T+2”.

Legal Entity Identifier (LEI) and Unique Swap Identifier (USI)

148. With respect to the mandatory reporting obligation, we received a few suggestions on the issue of LEIs and USIs. One respondent suggested that we should require entities trading in Hong Kong to register for an LEI, and also require that a USI be included in any direct reporting to the HKMA-TR. Another respondent pointed out that the introduction of an interim LEI regime may be costly for market participants if they and the relevant third-party service providers are required to incorporate the interim LEI regime into their systems and subsequently migrate to an agreed global LEI regime.

149. We appreciate the concerns raised. We will stay vigilant in respect of the development of a globally agreed LEI regime. However, if this is not available when Hong Kong implements the mandatory reporting regime, we will have no option but to implement an interim LEI regime for reporting the identity of counterparties involved in an OTC derivatives transaction. Our current thinking is to have an interim regime that will permit the use of a range of commonly used identifiers (such as HKMA-TR member's number, SWIFT BIC, Hong Kong company's registration/certificate of incorporation number, Hong Kong business registration number, internal customer number), and these will be ranked in order of priority (i.e. the highest ranking one that is available must be used). Hence, for example, the lowest ranking identifier will be an institution's readily available internal customer number. We believe this should help alleviate concerns about the cost implications of supporting a short-lived interim LEI regime. More details on the issue of identifiers will be provided when we consult on the detailed requirements in Q4 this year.

Grace period

150. In the Consultation Paper, we proposed that there should be a grace period for reporting so that persons who are not already subject to the reporting obligation have enough time to: (i) set up their reporting channel to the HKMA-TR (3 months), and (ii) complete any backloading (6 months, including the aforesaid 3 months). While the grace period was generally welcomed by respondents, a few respondents felt that the proposed grace period was too short and suggested a grace period of 6 months for first time implementation and a longer grace period for offshore entities / overseas branches. One respondent also suggested that market consultation should be conducted to determine the appropriate grace period.
151. We have given further consideration to the proposed grace period in view of the comments submitted. We remain of the view that the proposed grace periods of 3 months and 6 months are reasonable and lenient as compared with the practices in some other major financial centres. We therefore propose to stay with these. In any event, details of any grace periods, and how they apply, will be set out in subsidiary legislation and hence more specifics in this regard will be provided when we consult on this in Q4 this year.

Reporting obligation of a fiduciary

152. One respondent sought clarification as to whether a fiduciary (e.g. an investment manager) would have to report a reportable transaction executed on behalf of its clients. We do not propose to impose separate reporting obligations on fiduciaries. That said, we acknowledge that in the case of funds it may be necessary to provide further clarification as to who is responsible for fulfilling a reporting obligation and how. In this regard, our initial thinking is as follows –
- (1) The reporting obligation in respect of a fund could rest, for example, with the legal owner of the assets of the fund (e.g. the trustee, if the fund is structured in the form of a trust).
 - (2) The reporting threshold should be triggered at a fund level. However, for an umbrella fund, where each sub-fund operates as a separate unit and its respective portfolio is segregated from other sub-funds, the reporting obligation could apply at a sub-fund level.

More details on how the reporting obligation will apply in relation to funds and sub-funds will be provided when we consult on the detailed requirements in Q4 this year.

153. We would also note here that investment managers who manage portfolios of OTC derivatives transactions in Hong Kong will need to be licensed for the expanded Type 9 RA (see paragraphs 240 to 243 below, and Section IV of Appendix 2). As such, they will be LCs, and will need to report transactions with a Hong Kong nexus that they have originated or executed on behalf of a fund.

Reporting arrangement to cater for the effect of central clearing

154. The Consultation Paper did not discuss the reporting arrangements in respect of transactions that are centrally cleared. We take this opportunity to clarify our views on this issue.
155. Where a reportable transaction is to be centrally cleared (and irrespective of whether this is done voluntarily or because central clearing is mandated), we propose that the counterparties to the original transaction should be required to –
- (1) report to the HKMA-TR the fact that the transaction is anticipated to be cleared at a CCP,
 - (2) include in its reporting such further information as the HKMA-TR may reasonably require (e.g. name of the CCP), and
 - (3) keep the HKMA-TR informed on an on-going basis of any subsequent changes arising from life cycle events as if the original transaction had not been centrally cleared.
156. In this regard changes of life cycle events will not include any termination of the original contract and creation of new contracts as part of the central clearing process. Hence, it will not be necessary for either the CCP or the original counterparties to report the novated transactions to the HKMA-TR.
157. As these matters will be set out in the subsidiary legislation, more details will be provided when we consult on the subsidiary legislation in Q4 2012.

D. Proposed mandatory clearing obligation

Position of AMBs

158. As mentioned earlier, the Consultation Paper did not specifically discuss the position of AMBs. We take this opportunity to clarify that AMBs will be subject to the mandatory clearing obligation along similar lines as AIs and LCs. That said, we note that AMBs do not typically become counterparty to OTC derivatives transactions, and hence in practice, the mandatory clearing obligation may likely have little, if any, impact on them.

Origination and execution

159. Similar to the comments received on reporting, there was opposition to the clearing requirement for trades that are merely originated or executed by AIs or LCs. In view of the feedback, we propose to remove the “originated or executed” requirement for mandatory clearing. In other words, we now propose that the mandatory clearing

obligation will only apply if one of the counterparties is an AI, LC, AMB or Hong Kong person.

160. We believe this revised proposal suffices as transactions that are originated or executed in Hong Kong are likely to still be subject to mandatory clearing obligations under the laws of the jurisdictions in which they are booked. This will also help reduce overlap with clearing requirements imposed by overseas regulators.
161. A point to highlight here is that this change will also render redundant an exemption that we had previously proposed. Specifically, we had previously proposed that the clearing obligation should be exempted in respect of transactions where both parties are overseas persons, and the transaction is centrally cleared in accordance with the laws of an acceptable overseas jurisdiction, or exempted from mandatory clearing under those laws (see paragraphs 7(7) and 110(2) of the Consultation Paper). Given that the clearing obligation will now only apply where at least one party is an AI, LC, AMB or Hong Kong person, it follows that the mandatory clearing obligation will never apply to transactions where both counterparties are overseas persons (since “overseas persons” refer to persons other than AIs, LCs, AMBs and Hong Kong persons). The earlier exemption will thus be redundant. (This change is reflected in the revised flowchart at Appendix 4, which no longer refers to the limited exemption where both counterparties are overseas persons.)

Responsibility of AI/LC to ensure compliance with the clearing obligation

162. In the Consultation Paper, we proposed that a trade should be cleared only when both counterparties have exceeded the clearing threshold. Most respondents noted that AIs and LCs are unlikely to be able to determine whether their counterparties have exceeded the clearing threshold and whether the clearing requirement has thus been triggered. They were therefore opposed to requiring AIs and LCs to ensure compliance with the clearing obligation. They also felt that the provision could not be fairly implemented unless certain mechanisms were put in place e.g. establishing a database of relevant public information, and providing AIs and LCs with indemnity for trades they do not clear because they have received a guarantee from their counterparties that they have not surpassed the clearing threshold.
163. We appreciate the concerns raised. In view of these, we propose as follows. A counterparty should confirm whether it is subject to the clearing requirement when it enters into an OTC derivatives transaction with another entity. The party receiving the declaration should maintain proper record of the declaration to facilitate possible enquiry or investigation by regulators in future. Where a person has acted in good faith with reference to the declaration received, he should not be regarded as having breached the clearing obligation. These matters will be incorporated as appropriate in the subsidiary legislation and further details will be available when we consult on this in Q4 this year.
164. As noted above, AMBs typically do not become counterparty to OTC derivatives transactions, and hence the mandatory clearing obligation should not normally apply to them. However, to the extent that they do become counterparties, the above discussion would apply likewise to them.

Exemptions from mandatory clearing

165. In the Consultation Paper, we did not propose exemptions for any particular types of transactions, or for transactions conducted by any particular types of market players.

Instead, we proposed that the clearing obligation would only be triggered if both parties to the transaction exceeded a clearing threshold. We also proposed a limited exemption where both counterparties to the transaction were overseas persons, and the transaction was centrally cleared in accordance with the laws of an acceptable overseas jurisdiction, or exempted from mandatory clearing under such laws.

166. Many respondents felt the above was not enough and suggested that blanket exemptions from clearing should also be provided in respect of certain types of transactions or certain types of market players. In particular, exemptions were sought in respect of: (i) special bodies such as central banks, (ii) end-users using derivatives to hedge commercial risks, (iii) intra-group transactions, (iv) pension funds, (v) transactions where only one counterparty is an overseas person, (vi) transactions involving market players from “closed markets”, (vii) transactions conducted through the Hong Kong branch of an overseas-incorporated AI, and (viii) transactions between counterparties that have no CCP in common. Separately, one respondent suggested that systemically important trades should be cleared domestically and overseas counterparties participating in such trades should not be granted any clearing exemption.
167. We have carefully considered the feedback on blanket exemptions from clearing, and see merit in providing for some of the exemptions sought. We note also that, as more jurisdictions provide details of their proposed OTC derivatives regulations, a clearer trend is emerging of the types of blanket exemptions that may be introduced in major jurisdictions like the US and the EU. In view of this, we are reconsidering whether to grant clearing exemptions, and if so to what extent. In particular –
- (1) We are prepared to consider granting clearing exemptions in respect of transactions with certain central banks, monetary authorities or public bodies charged with the management of public debt and reserves and the maintenance of market stability, as well as global institutions such as the International Monetary Fund, the Bank for International Settlements, etc. Criteria such as reciprocity will be taken into account when determining whether to grant exemption for central banks, monetary authorities and public bodies.
 - (2) We are also prepared to consider the possibility of introducing clearing exemptions in respect of intra-group transactions, albeit subject to certain conditions. In this regard, we note that requiring the clearing of intra-group transactions could substantially increase the capital and liquidity required by firms that centralise risk management in certain entities. It could also increase operational complexity for firms.
 - (3) Similarly, we are considering possible exemptions in respect of end-users that are non-financial entities and that use derivatives to hedge commercial risks.
 - (4) We also recognize that some form of exemption in respect of transactions involving participants from “closed markets”¹⁰ may be unavoidable. However, we would prefer to observe how other jurisdictions approach this issue before taking a view on it.

¹⁰ Footnote 6 above explains “closed markets” in more detail.

168. Specific details on exemptions from clearing will be provided when we consult on the detailed requirements in Q4 this year. Our proposals will take into account the range of exemptions being considered in other major financial centres.

Clearing for the purpose of consolidated supervision

169. In the Consultation Paper, we proposed that the HKMA may require a locally-incorporated AI to –
- (1) take into account positions held by one or more of its subsidiaries (as the HKMA may specify) when assessing whether it (the AI) has exceeded the clearing threshold, and then
 - (2) procure that clearing-eligible transactions entered into by such subsidiaries are centrally cleared through a designated CCP.
170. Similar to reporting, there was objection to the requirement for a locally-incorporated AI to clear OTC derivatives transactions on a consolidated basis. It was felt that subsidiaries should only be subject to the clearing obligation if they are located in Hong Kong or executing trades in Hong Kong (or with Hong Kong entities).
171. In our proposal, mandatory clearing of an OTC derivatives transaction applies only when both parties to the transaction have exceeded the clearing threshold. The purpose of the requirement for a locally-incorporated AI to procure its specified subsidiaries to comply with the clearing obligation is to prevent circumvention of the clearing obligation by spreading positions into subsidiaries. Therefore we believe this requirement is essential and should be maintained.
172. We would also add that this requirement only applies to locally-incorporated AIs because the HKMA is the home supervisor for such institutions. Additionally, if the aggregate positions of the locally-incorporated AI and its specified subsidiaries exceed the clearing threshold, both the AI and its specified subsidiaries will have to submit their respective clearing eligible transactions to central clearing. However, in the case of the subsidiary's transactions, the obligation to centrally clear will rest with the AI (i.e. it is the AI that will be liable for any failure to clear such transactions), except that if the subsidiary itself has exceeded the threshold, then the subsidiary will be liable for any failure to clear such transactions.
173. The HKMA will determine the subsidiaries to be specified for the purposes of this requirement on a case-by-case basis having regard to the specific circumstances of individual locally-incorporated AIs.

Clearing threshold

174. In the Consultation Paper, we proposed to apply a clearing threshold in respect of all persons. We intended to set the clearing threshold on a per product class basis and to refer to the average notional value of a person's outstanding positions for the previous six months based on its month-end position when assessing if the clearing threshold has been exceeded. To reduce the compliance burden, we also proposed to provide an exit threshold, which would be set at a lower level than the clearing threshold.

175. Most respondents were supportive of the clearing threshold, although a few objected to it. We also received some suggestions on the methodology for setting the clearing threshold, including the following –
- (1) Apply the threshold to non-financial entities but not to financial entities.
 - (2) Design different thresholds for different transactions and counterparties.
 - (3) Apply the threshold only to Hong Kong persons and other buy-side firms.
 - (4) Do not apply the threshold to AIs, LCs or Hong Kong persons.
176. We welcome the general support for the clearing threshold. We also acknowledge the comments and suggestions put forward but do not see strong justification to make any of the changes suggested. We therefore propose to stay with our earlier proposal for now. In any event, more information on thresholds, and their operation, will be provided when we consult on the detailed requirements in Q4 this year.

De-clearing

177. Several participants noted the importance of allowing and encouraging the industry to de-clear trades, particularly for the purposes of trade compression¹¹ to reduce counterparty risk.
178. We agree and will incorporate appropriate provisions to permit de-clearing under our regulatory regime.

Grace period

179. In the Consultation Paper, we proposed a 3-month grace period when a person first exceeds the clearing threshold. We also proposed that such grace period should not in any event expire within the first 6 months from implementation of the mandatory clearing obligation. Hence, if a person exceeds the clearing threshold within the first 3 months from implementation, a slightly longer grace period will apply. The grace period arrangements were supported by all respondents that expressed views on this issue. A few respondents suggested that there should be a longer grace period, especially for overseas subsidiaries and branches. One respondent also suggested providing a transition period whenever a new product becomes subject to the mandatory clearing requirement.
180. We welcome the strong support for grace period arrangements. We also acknowledge the various comments and suggestions put forward, but do not at this stage consider it necessary to change the 3-month and 6-month grace periods previously proposed. We would also note that the same 3-month and 6-month grace periods will be available whenever the range of clearing eligible transactions is extended to cover a new product type, and hence do not consider it necessary to introduce a transition period as well. In any event, details of any grace periods, and how they apply, will be set out in subsidiary legislation and hence more specifics in this regard will be provided when we consult on this in Q4 this year.

¹¹ In general, trade compression involves replacing a large number of trades with a fewer number of trades to reduce the overall notional size and the number of contracts outstanding without changing the overall risk profile or present value of the portfolio.

E. Proposed mandatory trading obligation

- 181. We explained in the Consultation Paper that further study is needed to assess how best to implement a trading requirement in Hong Kong. In view of this, we proposed not to impose a mandatory trading requirement at the outset and sought views in the Consultation Paper on such proposal.
- 182. There was general support for not imposing the mandatory trading requirement at the outset. Careful assessment of the liquidity levels and the number of potential trading venues were considered to be crucial before introducing any trading requirement. A few respondents also emphasized the importance of retaining flexibility in the design of any trading requirement.
- 183. We share the views of respondents that there is a need to look further into the liquidity level and number of trading venues in our market before determining how best to implement a mandatory trading obligation. We will therefore not introduce a mandatory trading obligation at the outset and will continue to explore what appropriate measures should be taken to implement the trading requirement in Hong Kong.

F. Penalties for breach

- 184. We noted in the Consultation Paper that we believe it is necessary to impose penalties for breach of the mandatory obligations, and to ensure that such penalties are comparable to those imposed in major jurisdictions elsewhere.
- 185. While respondents generally accepted the need for penalties, they also raised a few concerns. In particular –
 - (1) It was suggested that market participants should not be penalised for failing to comply with the mandatory clearing obligation if the failure was beyond their control, and that instead a grace period should be introduced to allow market participants to either undo the transaction in question or take steps to secure compliance with the clearing obligation.
 - (2) Similarly, for the mandatory reporting obligation, it was suggested that a market participant should not be responsible for reporting errors committed by its agent (unless there was wilful breach or gross negligence on the part of the market participant), and a grace period should be allowed to correct innocent mistakes.
- 186. We appreciate the concerns raised and propose to build in sufficient flexibility to address these.
- 187. First, as discussed under paragraphs 146 to 147 above, we now intend to require compliance with the mandatory reporting obligations by T+2 days (rather than T+1 day as previously proposed). This should provide some leeway for market participants to ensure compliance with the obligations.
- 188. Secondly, we are considering including specific provision in the subsidiary legislation to clarify when failures to comply with a mandatory reporting or clearing obligation may be excused. More detail in this regard will be provided when we consult on the draft subsidiary legislation later this year.

189. Thirdly, as indicated in the Consultation Paper, we propose to introduce a civil penalty regime whereby civil or administrative fines may be imposed for breach of the mandatory obligations. This will be achieved by introducing a new provision in the SFO that allows the Court of First Instance to impose civil fines of up to a specified amount¹² on any person who breaches the mandatory obligations. We will consider if it is possible to build in some leeway to allow for events outside a person's control.
190. Apart from the civil penalty regime, we also propose that the HKMA and SFC should be able to take disciplinary action against any AI, AMB or LC that breaches the mandatory obligations.¹³ This will be achieved by expanding the existing disciplinary regime under Part IX of the SFO as appropriate. In keeping with the existing regime under Part IX –
- (1) the HKMA and SFC (as the case may be) will have to give the AI, AMB or LC concerned a reasonable opportunity of being heard before taking any disciplinary action, and will thus need to take all relevant facts and circumstances into account before deciding to take such action, and
 - (2) the AI, AMB or LC concerned may apply to the Securities and Futures Appeals Tribunal for a review of any disciplinary decision taken by the HKMA or SFC (as the case may be).
191. Therefore, any representations that a market participant makes regarding its failure to observe a mandatory obligation will be considered by the relevant regulator as part of the decision-making process.
192. Separately, some respondents also suggested that the legislation should expressly clarify that –
- (1) no liability for damages will arise from a party's failure to comply with the mandatory clearing obligation in Hong Kong, and
 - (2) even if a transaction is not submitted for central clearing as required by the mandatory clearing obligation, this should not affect the validity and enforceability of the transaction.
193. We note the concerns raised, and will consider how best to address these. Further details will be provided when we consult on the subsidiary legislation later in the year.

G. Designation and regulation of CCPs

194. The Consultation Paper invited feedback on various issues concerning the designation and regulation of CCPs as discussed below.

¹² We have yet to determine the specified amount, and will do so by reference to fines imposed in other major jurisdictions. Additionally, and to the extent appropriate, we will also take into account fine levels applicable to other breaches of reporting obligations under the SFO.

¹³ In keeping with the division of regulatory responsibility discussed in paragraphs 72 to 78 above, the expanded disciplinary regime will make clear that, with respect to breaches of the mandatory obligations, the HKMA will be responsible for investigating and taking disciplinary action against AIs and AMBs, while the SFC will be responsible for investigating breaches by other persons (including LCs), and for taking disciplinary action against LCs.

Requirement to be an RCH or authorized ATS provider

195. First, we proposed that both local and overseas CCPs should be eligible to become designated CCPs for the purposes of the mandatory clearing obligation, but that they first had to be either an RCH or an authorized ATS provider.
196. Most respondents welcomed the proposal to allow both local and overseas CCPs to become designated CCPs noting that the acceptance of overseas CCPs was necessary in order to provide choice to market players, prevent fragmentation along jurisdictional lines and help market players reconcile conflicting obligations under different jurisdictions. One respondent also noted the importance of ensuring that CCP designation does not become unreasonably difficult to obtain.
197. Many respondents emphasised that designated CCPs must be regulated to a level that is on a par with international standards. A few added that local CCPs would also need to meet US and EU requirements if they were to offer clearing services for transactions involving US or EU counterparties. A number of respondents put forward specific suggestions in this regard including on –
- (1) the criteria for membership of a designated CCP,
 - (2) the criteria for access to a designated CCP's services,
 - (3) the need for an appropriate balance between the amount of initial margins called for, and the amount of contributions to the default fund,
 - (4) a designated CCP's facilities for segregation and portability of client assets,
 - (5) a designated CCP's default arrangements, including any auction process,
 - (6) the obligations and liabilities of a designated CCP's members in the event of a default arising, and
 - (7) the involvement of non-dealers and clients in a designated CCP's governing board and risk management committees.
198. We welcome the generally positive feedback. We take this opportunity to clarify that we do intend to refer to international standards when assessing the suitability of a CCP to be designated. Specifically, we intend to draw reference to standards set by standard setting bodies such as CPSS-IOSCO.
199. Additionally, some respondents suggested an interim transitional arrangement for designating overseas CCPs. Essentially, they suggested that overseas CCPs from certain acceptable overseas jurisdictions should be temporarily regarded as designated CCPs while their formal application to be so designated was being considered.
200. While we appreciate the reasons behind the suggested transitional arrangement, we are not inclined to pursue it. Given the significant role that designated CCPs will play, we do not believe it is appropriate to confer such designation without completing the formal application process. That said, we will endeavour to process applications for CCP designation as efficiently as possible so as to limit any market disruption.

Location requirement

201. The Consultation Paper also sought views on whether a location requirement should be imposed for certain products that are considered systemically important to Hong Kong such that they may only be cleared through a local CCP.
202. One respondent strongly supported introducing a location requirement, noting that OTC derivatives that are regarded as being systemically important should be cleared through domestic CCPs that are regulated as RCHs. However, most respondents strongly opposed this proposal. Generally, they felt that a location requirement was unnecessary, would fragment liquidity, break netting sets, increase costs and not necessarily decrease systemic risk.
203. We note the concerns raised. In view of these, we do not propose to introduce a location requirement at this stage. However, we will keep this issue under review as the new OTC reforms evolve and are implemented globally.

Acceptability of overseas clearing members

204. Thirdly, we invited views on whether local CCPs should be allowed to accept overseas members (i.e. remote members). Respondents who commented on this proposal generally supported it. Only one respondent objected.
205. Respondents did however note that overseas members should only be accepted if they are from a suitable jurisdiction, i.e. a jurisdiction whose laws would not prevent or challenge the application and enforcement of the CCP's default rules and procedures in the event of the overseas member's default.
206. We acknowledge that there is a need for local CCPs to be allowed to accept overseas members given the global nature of the OTC derivatives market and the players in it. However, we also acknowledge the importance of ensuring that the local CCP can enforce its rules against its overseas members and will not be prevented from doing so under the laws of its members' home jurisdiction.
207. Accordingly, we propose that local CCPs should be able to accept overseas clearing members (i.e. remote members), but only if such members' clearing activities are regulated under the laws of an "acceptable overseas jurisdiction".
208. In determining whether a jurisdiction is an "acceptable overseas jurisdiction", reference will be made to various factors including –
 - (1) whether the laws of that jurisdiction regulate the clearing activities of the overseas person to a level comparable to that in Hong Kong for the regulation of OTC derivatives market,
 - (2) the enforceability of the local CCP's rules (in particular, rules relating to default management, and to porting of margin and collateral, in the event of the overseas member's default) against the overseas member and any property of the overseas member provided as collateral, and
 - (3) the adequacy of any MoUs or other regulatory cooperative arrangements with relevant regulators in that jurisdiction.

Indirect clearing

209. The Consultation Paper noted that we intended to facilitate indirect clearing (or client clearing), and sought views on how the insolvency override provisions and other protections under Part III of the SFO should be extended to support indirect clearing, and any segregation and portability arrangements put in place by designated CCPs.
210. Respondents who commented on this proposal generally supported indirect clearing, but also noted the importance of ensuring ring-fencing, segregation and portability of client assets in order to achieve the same level of protection as is currently enjoyed in the bilateral market. One respondent also suggested that indirect clearing be rolled out in a subsequent phase.
211. We welcome the positive feedback and propose to proceed with facilitating indirect clearing. We also believe it is not possible to defer indirect clearing to a later phase. This is because not everyone that is subject to the mandatory clearing obligation will be able to become a member of a designated CCP, and hence an alternative solution needs to be available to them from the outset.
212. In terms of the specific amendments that should be introduced to support indirect clearing, we received a number of useful comments and suggestions including –
- (1) specific suggestions on extending the definition of “market contract” (which is central to the insolvency override provisions),
 - (2) specific suggestions on what arrangements the extended insolvency override protections should cover, and
 - (3) what clarifications and confirmations the legislation should provide for, including the specific matters that might benefit from being given express statutory backing.
213. We appreciate the very useful feedback received on this aspect of the proposals.
214. We agree that the definition of “market contract” needs to be amended, and propose that it be extended to cover OTC derivatives transactions that are entered into by an RCH in accordance with its rules, i.e. there will be no prerequisite for the transactions to be traded on any particular platform, or to be novated.
215. We also agree that the above may not suffice to support client clearing and that further amendments may be needed. We are however still considering the specifics in this regard. We will make reference to how other jurisdictions intend to provide for client clearing, and provide further information of our thinking on this issue when we consult on the subsidiary legislation later this year.

Other issues

216. Two other issues raised by respondents in the context of designated CCPs are worth mentioning here.
217. First, there was a suggestion to amend section 52(2) of the SFO. Section 52(2) confirms that an RCH may apply collateral in accordance with its rules, and do so notwithstanding any prior equitable interest or right, or any right or remedy arising from a breach of fiduciary duty. However, this confirmation does not apply where the RCH has actual notice of the prior interest, right or breach. It was suggested that the confirmation should

apply even where the RCH had actual notice of the prior interest, right or breach, so as to ensure the ability of the RCH to use the collateral in any default scenario.

218. We do not consider it necessary to make this change. We believe it is appropriate to expect an RCH to exercise a reasonable level of diligence when accepting collateral. To do otherwise, may have moral hazard implications.
219. Secondly, there was a suggestion that section 54 of the SFO may be too robust and may cause issues for an RCH attempting to gain recognition as a CCP in a foreign jurisdiction. In particular, the complete exclusion of foreign insolvency law (particularly in relation to clearing members incorporated in such foreign jurisdiction) may cause concerns for foreign regulators.
220. We agree that it is important to ensure that section 54 does not compromise a local CCP's ability to gain recognition in a foreign jurisdiction. We will study the issue further and propose legislative amendment if necessary.

H. Capital charges and margin requirements

221. The Consultation Paper noted that we were considering whether to impose higher capital requirements and margin requirements for non-cleared OTC derivatives transactions. We received different views on this issue, and also requests for further clarification and consultation.
222. As these matters are currently being studied by the BCBS and IOSCO joint Working Group on Margin Requirements,¹⁴ we do not consider it appropriate to put forward any proposals until after that working group's final report is issued. We will also consult the market on specifics before introducing any capital or margin requirements for non-cleared OTC derivatives transactions. The HKMA will also separately consult the banking and deposit-taking industry associations on any relevant guidance issued by the BCBS.

I. Regulation of intermediaries

223. The Consultation Paper proposed that persons who serve as intermediaries in the OTC derivatives market should be regulated. Specifically, we proposed that –
- (1) a new RA should be created to capture persons (other than AIs) that serve as dealers, advisers or clearing agents in this market, and
 - (2) AIs who play a similar intermediary role should continue to be overseen and regulated by the HKMA, and that they need not be licensed for the new RA.
224. Respondents generally supported the above approach but noted the need to ensure a level playing field as between AIs and LCs, and consistent standards across industry participants.

¹⁴ This joint working group issued a consultative document on 7 July 2012. The document presents initial policy proposals that would establish minimum standards for margin requirements for non-centrally-cleared derivatives. The proposals were developed in consultation with, and with the active participation of, the Committee on Payment and Settlement Systems and the Committee on the Global Financial System.

225. We welcome the general support and take this opportunity to clarify that although AIs will not need to be licensed (or registered) for the new RA, the HKMA and SFC will ensure that conduct requirements imposed on AIs and LCs in respect of their OTC derivatives activities as intermediaries are equivalent.
226. We also received a number of comments and questions on various matters relating to the regulation of intermediaries. In view of these, we believe a more detailed proposal on the scope of any new RA should be exposed to the market for comment. Accordingly, we will conduct a supplemental consultation on this issue which will be released at the same time as the release of this Conclusions Paper. (A copy of the supplemental consultation is also attached at **Appendix 2** for ready reference.) We invite interested parties to submit comments on the same by 31 August 2012. Meanwhile, we highlight below some of the main concerns raised by respondents, and our initial response to the same.

One RA vs two RAs

227. Our earlier proposal was that all three intermediary functions (i.e. dealing, advising and clearing agency functions) should be covered under a single Type 11 RA. However, on reflection, we believe it is better to group dealing and advising under a single new Type 11 RA, and to keep the provision of clearing agency services under a separate new Type 12 RA. This is because –
- (1) As we understand it, there may be market players that wish to provide only dealing services, or only clearing agency services, but advisory services are typically provided as part of the dealing services, rather than as a discrete service.
 - (2) A separate RA for the clearing agency function will also facilitate the drafting of related regulatory requirements (e.g. capital, margin and risk management requirements), as these are likely to be more stringent than for dealers and advisers.

Scope of the new RAs

228. The Consultation Paper sought views on whether the new RA should apply only in respect of OTC derivatives transactions that are subject to the mandatory obligations, or in respect of all OTC derivatives transactions. We also noted that our inclination was to cover all OTC derivatives transactions.
229. We received different views on this issue. Given that the international trend is towards covering all OTC derivatives transactions (rather than only those that are subject to mandatory obligations), we propose to proceed likewise. We believe this approach will also be less disruptive for market players. If the licensing requirement is tied to the mandatory obligations, then every time a new product type or transaction type is made subject to the mandatory obligations, market players will need to check and ensure that they, as well as their relevant officers and employees, are properly licensed, and if they are not, this may disrupt the smooth running of their business and operations.

Definition of the new RAs

230. In the Consultation Paper, we proposed that the definition of the new RA should be cast along the lines of the existing dealing and advising definitions in Schedule 5 to the SFO,

but with suitable amendments to take into account the particular characteristics of the OTC derivatives market. We also proposed two options for dealing with overlaps between the new RA and existing RAs, namely: (i) carving out existing RAs from the new RA and leaving the existing RAs unaffected, or (ii) amending the existing RAs to exclude activities falling under the new RA.

231. We received many useful comments and suggestions on this issue. The main issues raised are discussed below.

Overlaps with existing RAs

232. On the issue of overlaps between any new RA and the existing RAs, and the two options put forward in the Consultation Paper, we received different views. However, the vast majority who responded indicated a preference for the first option as it would keep the scope of existing RAs intact.
233. We welcome the strong support for the first option, i.e. to incorporate appropriate carve-outs so that if a person's OTC derivatives activities are limited to activities that fall within the scope of an existing RA, then they should be able to continue on the basis of their existing licence and need not seek a licence for any new RA.
234. We acknowledge that this approach will effectively mean that market participants can engage in certain OTC derivatives activities under different licences (e.g. they can deal in OTC equity derivatives by being licensed for either Type 1 or Type 11 RA). However, we intend that any conduct requirements imposed on OTC derivatives market participants will be applied equally as appropriate. Hence, for example, market participants who deal in or advise on OTC equity derivatives will be subject to the same conduct requirements irrespective of whether they conduct their activities on the basis of a licence to carry on one of the existing RAs or on the basis of a licence to carry on the proposed new Type 11 RA.

Exemptions and carve-outs

235. Some respondents suggested that the definition of the new RA should include carve-outs similar to those under existing RAs, in particular there should be carve-outs for transactions conducted on a principal-to-principal basis or with professional institutional investors, and for intra-group transactions. There were also suggestions to carve out transactions entered into for commercial hedging or risk management purposes.
236. We agree that some of the carve-outs under the existing RAs should be echoed in the new RA, but not all. In particular, we do not agree that the scope of the new RA should exclude transactions conducted on a principal-to-principal basis given that OTC derivatives transactions are often entered into on a principal-to-principal basis. As for intra-group transactions or commercial hedging transactions, we discuss these and other exemptions and carve-outs in more detail in the supplemental consultation at Appendix 2 – see in particular paragraphs 12 and 13 of the supplemental consultation.

Position of AMBs

237. As noted in paragraphs 73 to 76 above, we agree that the OTC derivatives activities of AMBs (who essentially serve as intermediaries in the OTC derivatives markets rather than take on positions as principal) should be overseen and regulated by the HKMA rather than the SFC. Accordingly –

- (1) We do not propose to require AMBs to be licensed for either the new Type 11 RA or Type 12 RA.
- (2) However, to the extent that their OTC derivatives activities also constitute either Type 1 RA (dealing in securities) or Type 3 RA (leveraged foreign exchange trading), they will continue to have to be licensed and regulated by the SFC for those RAs.¹⁵

(See in particular paragraphs 12(2) and 28(2) of the supplemental consultation at Appendix 2.)

238. The above echoes the approach proposed to be taken in respect of AIs, i.e. they will not need to be licensed (or registered) for the new Type 11 RA or Type 12 RA, but to the extent that their OTC derivatives activities fall within the scope of any of the existing RAs, they will have to continue to be registered for those.
239. We also note here that, in any event, the HKMA and SFC will work together to ensure that regulatory requirements applicable to AIs, LCs and AMBs in respect of their OTC derivatives activities are aligned and consistently applied so as to maintain a level playing field among different market players.

Asset managers

240. A number of respondents noted that asset managers licensed for Type 9 RA (asset management) should not be required to be licensed for the new RA as well if their activities are merely incidental to their carrying on Type 9 RA. Instead, the existing Type 9 RA should be expanded so that it covers the management of portfolios of OTC derivatives transactions as well.
241. We agree that asset managers licensed for Type 9 RA should be exempted from the new RA and that the scope of Type 9 RA should be expanded to cover OTC derivatives transactions. (See in particular paragraph 12(6) and section IV of the supplemental consultation at Appendix 2.)
242. A point to note here however is that the expanded Type 9 RA should, in our view, apply to AIs and AMBs as well, although we also propose to correspondingly expand the “incidental” carve-out under paragraph (c) of the definition of “securities or futures contracts management” in Schedule 5 to the SFO (see paragraph 31 of the supplemental consultation at Appendix 2).
243. In other words, we propose that AIs and AMBs should still need to be licensed or registered for the expanded Type 9 RA if their OTC derivatives activities fall within its expanded ambit, and cannot be regarded as wholly incidental to their activities as OTC derivatives dealers.

¹⁵ In other words, to the extent that the OTC derivatives activities of an AMB constitute “dealing in securities” (as defined in Schedule 5 to the SFO), but do not fall within the carve-out under paragraph (xv) of that definition, it will still need to be licensed for Type 1 RA. Likewise, to the extent that the OTC derivatives activities of an AMB constitute “leveraged foreign exchange trading” (as defined in Schedule 5 to the SFO), but do not fall within the carve-out under paragraph (iv) of that definition, it will still need to be licensed for Type 3 RA.

Post-trade services

244. There was also some concern that the provision of certain post trade services (such as portfolio compression services and other risk reduction services) should not be considered as falling within the scope of the new RA.
245. We note the concerns about post trade services. While we do not expect such services to fall within the scope of the new RA, we do expect that providers of such services may need to be authorized to provide ATS – e.g. a provider of trade compression services which constitute trade matching. (See also paragraph 12(1) of the supplemental consultation at Appendix 2 which exempts authorized ATS providers from having to be licensed for a Type 11 RA.)

How new RAs will be cast

246. In view of the matters noted in paragraphs 223 to 245 above, we propose to cast the new Type 11 RA and Type 12 RA, and to expand the existing Type 9 RA, along the lines set out in the supplemental consultation paper at Appendix 2. The supplemental consultation also elaborates on the various matters discussed in paragraphs 230 to 245 above.

Transitional arrangements

247. A few respondents asked whether there would be a grace period or transitional period before any new RA comes into effect. We agree that transitional arrangements are needed for the new RAs as well as the expanded Type 9 RA so as to limit any market disruption. Details of these are set out in Appendix 2 as well.

Application of section 115

248. A few respondents sought clarification on the extra-territorial effect of the new RAs, noting that the new RA should not affect the offshore booking model which is permissible under the current regime.
249. We confirm that –
- (1) the licensing requirement for Type 11 RA and Type 12 RA will only apply to persons who carry on business in Hong Kong, and
 - (2) for persons carrying on a business of dealing in, advising on or providing clearing agency services in respect of OTC derivatives outside Hong Kong, section 115 of the SFO will continue to apply, i.e. so long as their dealing, advising or clearing agency services are not actively marketed to the Hong Kong public, they will not be regarded as carrying on Type 11 or Type 12 RA.
250. We would also clarify here that, to the extent that remote members of a Hong Kong CCP may be regarded as carrying on their clearing agency business in Hong Kong, we propose to clarify in the legislation that they will not need to be licensed for Type 12 RA if –
- (1) their activities as clearing agents are regulated under the laws of an acceptable overseas jurisdiction (i.e. to a level that is comparable to the regulation of clearing agents in Hong Kong), and

- (2) they either –
 - (a) do not provide services to persons in Hong Kong, or
 - (b) if they do, then any marketing of those services to persons in Hong Kong is conducted by an AI or LC.

(See paragraph 28(3) of the supplemental consultation at Appendix 2.)

- 251. However, where overseas persons provide clearing agency services to persons in Hong Kong, but as a clearing member of an overseas CCP, then section 115 of the SFO will apply. Accordingly, so long as their clearing agency services are not actively marketed to the public in Hong Kong, they will not be regarded as carrying on Type 12 RA.

J. Oversight of SIPs

- 252. Apart from regulating intermediaries, we also proposed that the SFC should have regulatory oversight of SIPs in the OTC derivatives market, i.e. persons in Hong Kong who are not otherwise regulated by the SFC or HKMA but whose positions or activities raise concerns of potential systemic risk.
- 253. Essentially, we proposed that such players should not have to be licensed but should instead be subject to certain specific obligations, e.g. providing information about their OTC derivatives activities and transactions, and taking steps to reduce their OTC derivatives positions in certain circumstances.

Concerns and comments

- 254. We received a number of comments on this issue. In general, respondents agreed that SIPs should be subject to regulatory oversight given the potential impact they could have on the market and the financial strength of a CCP. However, respondents asked for further clarity as to who would be regarded as an SIP, and the specific obligations that an SIP would be subject to. A few respondents also suggested that entities that are end-users or that use OTC derivatives to hedge commercial risks should in any event not be classified as SIPs.
- 255. We do not agree that end-users or others using OTC derivatives to hedge commercial risks should be excluded from being regarded as SIPs if their positions and activities are such as to raise concerns of potential systemic risk. Indeed, the objective of this proposal is precisely to enable regulators to have some oversight of the activities of end-users, price takers and others who are not already regulated by the HKMA or SFC and hence not already on their radar.

How SIPs will be regulated

- 256. However, in view of the feedback received, we propose to refine our proposals vis-à-vis SIPs, and give market participants an opportunity to comment on them. Accordingly, our proposals vis-à-vis the regulatory oversight of SIPs are also set out in the supplemental consultation at Appendix 2. In brief, our current thinking is as follows –
 - (1) We propose to use only quantitative criteria to determine whether a person should be regarded as an SIP or not. Their names and details of their positions will then be entered in a register of SIPs. The register of SIPs will be kept and

maintained by the SFC and information in it will be shared with the HKMA. We are however still considering whether names of SIPs entered in the register should be disclosed to the public.

- (2) We do not propose to require SIPs to be licensed or regulated as intermediaries, but we do feel that some form of registration with the SFC is necessary so that their activities can be more effectively monitored. For this purpose, we propose that notification to the SFC and then registration in the register of SIPs should suffice.
- (3) We propose that SIPs who are registered with the SFC will then be overseen and regulated by the HKMA and SFC. The specific powers proposed to be given to the regulators will include powers to require an SIP to –
 - (a) provide such information regarding its activities and transactions in the OTC derivatives market as specified, and
 - (b) take such action in respect of its OTC derivatives positions, or in respect of any collateral collected or posted, as specified if the regulators have reasonable cause to believe that the SIP's activities or transactions in the OTC derivatives market pose, or may pose, systemic risk.
- (4) Lastly, we propose to extend the existing disciplinary provisions under Part IX of the SFO so that SIPs who fail to provide information or take action as required may be subject to disciplinary action by the SFC (i.e. public/private reprimand and disciplinary fines of up to HK\$10 million).

IV. Concluding remarks and next steps

- 257. We are grateful for the many comments and suggestions submitted in response to our Consultation Paper. These have been critical in helping us to refine some of the key aspects of the new regime as discussed in this Conclusions Paper.
- 258. The reform and regulation of the OTC derivatives market is significant for both the market and regulators. The issue of this paper marks a key milestone in that process, but much remains to be done. We intend to continue maintaining a close and regular dialogue with the industry as this reform effort progresses. We also continue to welcome views and discussion with interested parties.
- 259. As indicated in this paper, we will be conducting two further public consultations –
 - (1) a consultation on the scope of the new RAs and expanded Type 9 RA, as well as the regulation of SIPs, and
 - (2) a consultation on the detailed requirements under the new OTC derivatives regime which will be set out in subsidiary legislation.
- 260. The first of these will last for about a month and a half, and we hope to conclude it before the issue of the second consultation on the detailed requirements in Q4 this year.
- 261. Separately, we will also be working with the Administration on the drafting of amendments to primary legislation. Our current target is to introduce a Bill on this subject into the Legislative Council in Q4 2012.

Appendix 1 – List of Respondents

(in alphabetical order)

1. Allen & Overy
2. Alternative Investment Management Association Limited, The
3. Anonymous – *one respondent requested that its identity not be published*
4. Anonymous – *two respondents requested that its identity and contents of its submission not be published*
5. Anonymous – *one respondent submitted two submissions and requested that one not be published*
6. APG Algemene Pensioen Groep N.V.
7. Ashurst Hong Kong
8. CFA Institute
9. Clifford Chance together with 10 clients
 - i. Bank of America Merrill Lynch
 - ii. Barclays Bank PLC
 - iii. BNP Paribas
 - iv. Citibank, N.A.
 - v. Deutsche Bank AG
 - vi. Goldman Sachs (Asia) LLC
 - vii. JP Morgan
 - viii. Morgan Stanley
 - ix. The Hongkong and Shanghai Banking Corporation Limited
 - x. UBS AG
10. CME Group Inc on behalf of its subsidiaries Chicago Mercantile Exchange Inc and CME Clearing Europe Ltd
11. DBS Bank Limited, Hong Kong Branch and DBS Bank (Hong Kong) Limited
12. Deacons
13. Depository Trust & Clearing Corporation, The
14. DTC Association, The
15. Global Foreign Exchange Division (of the Global Financial Markets Association)
16. Hongkong and Shanghai Banking Corporation Limited, The together with members of HSBC Group
17. Hong Kong Association of Banks, The
18. Hong Kong Exchanges and Clearing Limited
19. Hong Kong Investment Funds Association
20. Hong Kong Society of Financial Analysts, The
21. International Swaps and Derivatives Association, Inc
22. Law Society of Hong Kong, The
23. LCH.Clearnet Group Limited

24. Managed Funds Association
25. MarkitSERV LLC
26. SinoPac Securities (Asia) Limited
27. Standard Chartered Bank (Hong Kong) Limited
28. State Street Bank and Trust Company
29. Tanner De Witt on behalf of the Hong Kong Inter-Dealer Brokers Association
30. Tradeweb Europe Limited
31. TriOptima AB
32. Vicktor Capital (Asia) Limited
33. Vincent Cheng

Appendix 2 – Supplemental consultation on the OTC derivatives regime for Hong Kong – proposed scope of new/expanded regulated activities and regulatory oversight of systemically important players

Foreword

This paper is a follow-up to the Hong Kong Monetary Authority (**HKMA**) and Securities and Futures Commission (**SFC**)’s joint consultation on the proposed regulatory regime for the over-the-counter (**OTC**) derivatives market. The original consultation paper was issued in October 2011 and the Consultation Conclusions were issued in July 2012 (at the same time as the release of this supplemental consultation paper).¹

This paper sets out the HKMA’s and SFC’s proposals on how certain new regulated activities relating to OTC derivatives should be cast, and how systemically important players in that market should be regulated. Interested parties are invited to submit written comments by any one of the following methods on or before **31 August 2012**.

By online submission at: <http://www.sfc.hk/sfc/html/EN/speeches/consult/consult.html>

By email to: mdd@hkma.gov.hk or otcconsult@sfc.hk

By fax to: (852) 2878 7297 or (852) 2521 7917

By post to one of the following:

Market Development Division
Hong Kong Monetary Authority
55/F Two International Finance Centre
8 Finance Street Central
Hong Kong

Supervision of Markets Division
Securities and Futures Commission
8th floor Chater House
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Hong Kong

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¹ Copies of both the Consultation Paper and the Conclusions Paper are accessible via the HKMA’s and SFC’s website at www.hkma.gov.hk and www.sfc.hk respectively.

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8 Finance Street Central
Hong Kong

In the case of the SFC –
The Data Privacy Officer
The Securities and Futures Commission
8th floor Chater House
8 Connaught Road Central
Hong Kong

7. A copy of the Privacy Policy Statement adopted by the HKMA and SFC is available upon request.

I. Introduction and executive summary

1. In October 2011, the Hong Kong Monetary Authority (**HKMA**) and Securities and Futures Commission (**SFC**) issued a joint consultation paper on the proposed regulatory regime for the over-the-counter (**OTC**) derivatives market (**Consultation Paper**). A joint consultation conclusions paper (**Conclusions Paper**) was subsequently issued in July 2012.
2. The Conclusions Paper confirmed the need to regulate persons who serve as intermediaries (i.e. as dealers, advisers or clearing agents) in the OTC derivatives market, and to have a degree of regulatory oversight in respect of systemically important players (**SIPs**), i.e. players in Hong Kong who are not licensed or registered with either the HKMA or SFC, but whose positions and activities in the OTC derivatives market may raise concerns of potential systemic risk.
3. Specifically, the paper confirmed that –
 - (1) Two new regulated activities (**RAs**) would need to be introduced under Schedule 5 to the Securities and Futures Ordinance (**SFO**), namely –
 - (a) a new Type 11 RA to cover the activities of dealers and advisers, and
 - (b) a new Type 12 RA to cover the activities of clearing agents.
 - (2) Additionally, the existing Type 9 RA (asset management) would need to be expanded to cover the management of portfolios of OTC derivatives transactions.
 - (3) Authorized institutions (within the meaning of the Banking Ordinance, **AIs**) and approved money brokers (also within the meaning of the Banking Ordinance, **AMBs**) who serve as intermediaries in the OTC derivatives market would continue to be overseen and regulated by the HKMA, and hence would not need to be licensed for the new Type 11 or Type 12 RAs. However, to the extent that their OTC derivatives activities also constitute the carrying on of an existing RA (including the expanded Type 9 RA), they would continue to have to be licensed or registered (as the case may be) as they are today.
 - (4) Market players in Hong Kong whose OTC derivatives positions exceed a certain specified threshold (which threshold will be many times higher than both the reporting and clearing thresholds) should notify the SFC, and their names and details should then be entered in a register of SIPs. Additionally, the HKMA and SFC should have power to require SIPs to provide information and take certain action in respect of their OTC derivatives positions and transactions as may be required.
4. This paper sets out the HKMA's and SFC's specific proposals on how the new Type 11 RA and new Type 12 RA should be cast, how the existing Type 9 RA should be expanded, and how the activities of SIPs should be overseen and regulated. Briefly, we propose as follows –

New Type 11 RA

- (1) As with the existing RAs, the new RAs should be defined by first setting an initial ambit, and then refining this as appropriate by reference to specific exemptions and carve-outs.

- (2) The initial ambit of the new Type 11 RA should be cast along the lines of the initial ambit of the existing dealing and advising definitions in the SFO. Carve-outs should be provided for the following –
- (a) to deal with any overlaps between the scope of the new Type 11 RA, and the scope of one or more of the existing RAs,⁴
 - (b) to preserve, as appropriate, some of the carve-outs under the existing RAs, so that the introduction of the new Type 11 RA does not inadvertently remove the benefit of carve-outs that currently exist and should be retained for OTC derivatives transactions, and
 - (c) to exclude dealing and advising activities undertaken by certain types of persons, or in certain types of situations – e.g. activities undertaken by AIs and AMBs will have to be carved out as they will continue to be regulated by the HKMA and will not have to be licensed for the new Type 11 RA.

New Type 12 RA

- (3) The new Type 12 RA should cover the provision of clearing and settlement services where these are provided: (i) in respect of OTC derivatives transaction, (ii) through a central counterparty (**CCP**), and (iii) on behalf of another person. It should therefore encompass the activities of both –
- (a) members of a CCP, and
 - (b) persons that intermediate between such member and a counterparty to the OTC derivatives transaction in respect of which the clearing agency services are provided,
- except where such members or persons are clearing their own (proprietary) trades only.
- (4) Additionally, carve-outs should be provided to exclude: (i) the CCP itself, (ii) AIs and AMBs, (iii) overseas members of a local CCP (i.e. remote participants) provided certain conditions are met, and (iv) any agent of a clearing member that provides only marketing support and does not handle client monies or assets. With respect to agents of a clearing member, we propose that they should only be required to be licensed for Type 12 RA if they handle client monies or assets. This is in light of recommendations on the segregation and portability of client positions and collateral made in the IOSCO Report on International Standards for Derivatives Market Intermediary Regulation.

Expanded Type 9 RA

- (5) The Type 9 RA should be expanded so that it also encompasses the management of portfolios of OTC derivatives transactions. The existing carve-outs that allow persons licensed/registered for Type 1 RA to manage portfolios of

⁴ For example, with respect to OTC equity derivatives, there may be some overlap between the new Type 11 RA and the existing Type 1 RA (dealing in securities) and Type 4 RA (advising on securities). Similarly, with respect to foreign exchange derivatives, there may be some overlap with the existing Type 3 RA (leveraged foreign exchange trading).

securities without being licensed / registered for Type 9 RA should be similarly expanded so that AIs, AMBs and persons licensed for Type 11 RA may manage portfolios of OTC derivatives transactions without a licence/registration for the expanded Type 9 RA if such management is incidental to their dealing in OTC derivatives.

Transitional arrangements

- (6) To minimise disruption to market participants, we propose to introduce transitional arrangements for the implementation of the new Type 11 and 12 RAs, and the expanded Type 9 RA. Specifically, persons who wish to be licensed/registered for any of these RAs, and submit their applications within a specified period will be deemed to be so licensed or registered until their application is determined. The deeming is however subject to the applicant confirming that it has been engaging in relevant OTC derivatives activities in Hong Kong for an appropriate period of time before the new regulatory regime came into force.

Regulation of SIPs

- (7) We propose to use only quantitative criteria to determine if a person should be regarded as an SIP. Persons who meet such criteria will need to notify the SFC and their names and details of their OTC derivatives positions will then be entered in a register of SIPs. We are considering whether the names of SIPs entered in the register should be disclosed to the public.
- (8) The HKMA and SFC should have certain regulatory powers in respect of persons whose names are in the register of SIPs. Specifically, they should have powers to require such persons to provide information and take action in respect of their OTC derivatives positions and transactions as specified. Persons who fail to comply with such requirements should be subject to disciplinary action by the SFC, and the sanctions that may be imposed will include public/private reprimand and disciplinary fines of up to HK\$10 million. Decisions against SIPs should be subject to appeal before the Securities and Futures Appeals Tribunal.

5. This paper should be read together with the Consultation Paper and the Conclusions Paper.

II. Type 11 RA

6. As with the existing RAs, we propose that the new RAs should be defined by first setting an initial ambit, and then refining this as appropriate by reference to specific exemptions and carve-outs. In the paragraphs below, we set out our proposed initial ambit for the new Type 11 RA and our proposed list of exemptions and carve-outs.

Initial ambit

7. We propose that the initial ambit of the new Type 11 RA should encompass dealing in and advising on OTC derivatives transactions, and that this should be defined to mean any of the following –
 - (1) entering into or offering to enter into an OTC derivatives transaction,

- (2) inducing or attempting to induce another person to enter into, or to offer to enter into, an OTC derivatives transaction, and
 - (3) giving advice on, or issuing reports or analyses on whether, which, the time at which, or the terms or conditions on which, OTC derivatives transactions should be entered into.
8. The above is largely based on the initial ambit of the existing dealing and advising definitions under Schedule 5 to the SFO. With respect to the advising limb (i.e. paragraph 7(3) above), we have considered whether this should cover both the giving of advice and the issuing of reports and analyses, or only the former. The bespoke nature of OTC derivatives transactions suggests that the issue of reports and analyses may be unusual or rare. However, we note that derivatives transactions can also be standardised. Moreover, with the implementation of the new OTC derivatives regime (including higher margin requirements for transactions that are not centrally cleared), standardisation is likely to increase. This in turn may encourage the issue of reports and analyses. We therefore propose that, for completeness, the advising limb of the new Type 11 RA should include both the giving of advice and the issuing of reports and analyses.

Proposed carve-outs

9. It will be necessary to carve out a number of activities from the initial ambit. These include carve-outs to address overlaps with existing RAs, and carve-outs for specific activities.

Proposed carve-outs to address concerns of overlap

10. To address concerns of overlap between the new Type 11 RA and existing RAs, we propose to carve out the following activities from the scope of the new Type 11 RA –

- (1) ***Overlap with existing RAs:*** Activities that also constitute a Type 1 RA (dealing in securities), Type 2 RA (dealing in futures contracts), Type 3 RA (leveraged foreign exchange trading), Type 4 RA (advising on securities) or Type 5 RA (advising on futures contracts) and that are conducted by a person who is licensed to carry on such RA should be excluded from the scope of the new Type 11 RA. Additionally, to complement this carve-out, corresponding carve-outs should be added to each of Types 1, 2, 3, 4 and 5 RA so that persons licensed for a Type 11 RA need not also apply for a Type 1, 2, 3, 4 or 5 RA to the extent that their OTC derivatives activities also fall within the ambit of any of the latter.

This is the main “overlap” carve-out and is intended to avoid persons having to obtain a Type 11 RA if they can conduct the same activities using a Type 1, 2, 3, 4 or 5 RA and they are already licensed or registered to carry on such RA. Likewise, it also means persons who are already licensed for Type 11 RA would not need to apply for a Type 1, 2, 3, 4 or 5 RA as well if the scope of their OTC derivatives activities is covered by both.

Hence, for example, a person that deals in OTC equity derivatives on an agency basis only should be able to carry on that activity by virtue of being licensed for either Type 1 RA or Type 11 RA, i.e. it should not have to be licensed for both Type 1 RA and Type 11 RA. However, if the person wishes to deal in OTC equity derivatives on a principal-to-principal basis, then its existing licence for Type 1 RA will not suffice, and it will have to be licensed for the new Type 11 RA. This is because the scope of the existing Type 1 RA does not cover dealing in OTC equity derivatives on a principal-to-principal basis, whereas the proposed scope of the new Type 11 RA does (see paragraph 11 below).

- (2) **Dealings through a licensed dealer:** Activities that would also constitute a Type 1 RA (dealing in securities), Type 2 RA (dealing in futures contracts) or Type 3 RA (leveraged foreign exchange trading) but for the carve-out under, respectively, paragraph (iv) of the “dealing in securities” definition, paragraph (ii) of the “dealing in futures contracts” definition and paragraph (xiv) of the “leveraged foreign exchange trading” definition should be excluded.

Currently, persons who fall within the initial ambit of the “dealing in securities” (or “dealing in futures contracts” or “leveraged foreign exchange trading”) definition do not need to be licensed for Type 1 RA (or Type 2 or 3 RA) if they conduct their dealing activities for no remuneration, and through another person that is licensed for such RA.

Where such persons deal in products that also fall within the definition of “OTC derivatives transaction” (e.g. OTC equity derivatives may fall within the definition of “securities” and “OTC derivatives transaction”), they should be able to continue doing so without having to be licensed for the new Type 11 RA. Hence, for example, a person dealing in OTC equity derivatives through an LC licensed for Type 1 RA (and for no remuneration) should be entitled to continue doing so without having to be licensed for the new Type 11 RA, or having to go through an LC licensed for Type 11 RA. This carve-out seeks to achieve this.

- (3) **Communication of securities offers:** Activities that would also constitute a Type 1 RA (dealing in securities) but for the carve-out under paragraph (xiii) of the “dealing in securities” definition should be excluded.

Currently, persons who are licensed for Type 4 RA (advising on securities) or Type 6 RA (advising on corporate finance) can communicate offers of securities without a licence for Type 1 RA (dealing in securities), but only if their communication complies with the requirements of section 175 of the SFO.

We believe this carve-out should apply equally where the offer is of securities that are also OTC derivatives transactions (e.g. where the offer is of OTC equity derivatives). In other words, a person licensed for Type 4 RA or Type 6 RA should be able to continue communicating offers of OTC equity derivatives without having to be licensed for the new Type 11 RA provided the communication complies with section 175 of the SFO. However, if the person wishes to communicate offers of interest rate derivatives, then this carve-out would not apply and the person would need to be licensed for Type 11 RA.

- (4) **Advising incidental to dealing:** Activities that would also constitute a Type 4 RA (advising on securities) or a Type 5 RA (advising on futures contracts) but for the carve-out under, respectively, paragraph (ii) of the “advising on securities” definition, and paragraph (ii) of the “advising on futures contracts” definition should be excluded.

Currently, licensed dealers (i.e. persons licensed for Type 1 RA (or Type 2 RA)) can advise on securities (or futures contracts) without being licensed for Type 4 RA (or Type 5 RA) but only if their giving of such advice is incidental to their dealing activities.

The giving of such advice may fall within the scope of the new Type 11 RA as well. (For example, the giving of advice on OTC equity derivatives could fall within the scope of both Type 4 RA and the new Type 11 RA.) In view of this, and in order to ensure that the carve-outs described in this sub-paragraph (4) are preserved, we believe it is necessary to exclude them from the new Type 11 RA as well. This will ensure that, for example, a person licensed for Type 1 RA can continue to give advice on OTC equity derivatives without a licence for either Type 4 RA or Type 11 RA provided the giving of such advice is incidental to its securities dealing activities.

This carve-out only applies to licensed persons, and not to AIs who are registered institutions, i.e. carve-outs along the lines of paragraphs (iii) and (iv) of both the definitions of “advising on securities” and “advising on futures contracts” are not proposed. This is deliberate. As AIs’ activities are proposed to be carved out completely from the new Type 11 RA (see paragraph 12(2) below), we do not believe it is necessary to incorporate specific carve-outs along the lines of paragraphs (iii) and (iv) of the two advising definitions.

- (5) **Particular types of leveraged foreign exchange contracts:** Activities that would also constitute a Type 3 RA (leveraged foreign exchange trading) but for the carve-out under paragraph (i), (iii) or (vii) of the definition of “leveraged foreign exchange trading”.

Currently, the scope of Type 3 RA excludes activities in respect of certain types of leveraged foreign exchange contracts, namely –

- *contracts that are wholly referable to the provision of property (other than currency), services or employment at a fair market value,*
- *contracts with a money changer that relate to the exchange of different currencies, and*
- *contracts arranged by a central bank, an institution performing the functions of a central bank, or an organization acting on such bank or institution’s behalf.*

Such contracts may also fall within the definition of “OTC derivatives transaction” given the fairly wide scope of that definition – see paragraphs 79 to 85 of the Conclusions Paper. In view of this, and in order to ensure that the exclusions described above are preserved, we believe it is necessary to replicate these exclusions in the definition of the new Type 11 RA. This carve-out seeks to achieve this.

11. For completeness, we note here that we do not propose to expressly preserve any of the other existing carve-outs under the definition of “dealing in securities”, “dealing in futures contracts” or “leveraged foreign exchange trading”. In most cases, this is because they are either inappropriate or are covered by other proposed carve-outs discussed in paragraph 12 below. In particular, we do not consider it appropriate to preserve the “principal” carve-out under paragraph (v) of the “dealing in securities” definition and paragraph (vii) of the “dealing in futures contracts” definition. This is because transactions in the OTC derivatives market are typically conducted on a principal-to-principal basis. Excluding such transactions would therefore exclude a large part of the activity in the OTC derivatives market and thus defeat the rationale for introducing the new Type 11 RA.

Other proposed carve-outs

12. Apart from carve-outs to deal with overlaps between the new Type 11 RA and various existing RAs, we also propose that the scope of the new Type 11 RA should exclude the following activities, many of which are akin to carve-outs under the existing RAs –

- (1) the activities of recognized clearing houses (**RCHs**), recognized exchange companies (**RECs**), and **ATS** providers authorized under section 95 of the SFO, in their capacity as such,

These carve-outs aim to ensure that the new Type 11 RA will not capture the activities of RCHs, RECs and authorized ATS providers which may otherwise fall within the initial ambit discussed in paragraph 7 above. Such activities are also currently excluded from the scope of Type 1 RA and, to a lesser extent, from Type 2 RA. (See paragraphs (i) to

(iii) of the “dealing in securities” definition and paragraph (i) of the “dealing in futures contracts” definition.)

- (2) the activities of **Als and AMBs** in their capacity as such,

These carve-outs are to reflect the agreed division of regulatory responsibility between the HKMA and SFC vis-à-vis the OTC derivatives market – see paragraphs 15, 72 to 78, and 237 to 239 of the Conclusions Paper.

A point to highlight here is that neither this carve-out for Als and AMBs, nor the carve-out described in paragraph 10(1) above, will affect Als’ or AMBs’ obligation to be registered for any of the existing RAs to the extent that their OTC derivatives activities also constitute carrying on such existing RAs. Hence, for example, although an AI or AMB’s activities in respect of OTC equity derivatives will not require it to be licensed/registered for the new Type 11 RA, this should not affect the fact that the activities may nevertheless fall within the existing Type 1 RA and that the AI or AMB will still need to be licensed/registered for Type 1 RA.

- (3) dealing activities that constitute entering into a **market contract** (and for this purpose market contract will be amended as discussed in paragraph 214 of the Conclusions Paper⁵),

This carve-out is akin to the one under paragraph (vi) of the “dealing in securities” definition, and paragraph (v) of the “dealing in futures contracts” definition.

- (4) dealing activities **performed through** an AI or through an LC licensed for Type 11 RA, and for no remuneration,

This carve-out is akin to the one under paragraph (ii) of the “dealing in futures contracts” definition and paragraph (iv) of the “dealing in securities” definition. It serves to exclude the activities of end users to some extent, although we acknowledge that it will not cover end users who enter into OTC derivatives transactions directly (i.e. without going through an intermediary).

The proposed carve-out under this sub-paragraph (4) is similar to the one proposed under paragraph 10(2) above, and may therefore appear to be unnecessarily duplicative. However, the two are in fact different – the carve-out here aims to allow for dealings via any AI or an LC licensed for Type 11 RA, whereas the carve-out under paragraph 10(2) above aims to allow for dealings via an LC licensed for Type 1 RA, Type 2 RA or Type 3 RA.

- (5) the activities of **price takers** (i.e. persons who do not make markets or offer price quotes for OTC derivatives transactions),

This carve-out aims to exclude end users who enter into OTC derivatives transactions directly (i.e. without going through an intermediary). We are still considering how best to define price-takers and would welcome views in this regard.

- (6) the activities of a person licensed or registered for **Type 9 RA** (asset management) for the purposes of carrying on that RA,

This carve-out is akin to the carve-out under paragraph (vi) of the “dealing in futures contracts” definition, paragraph (xiv) of the “dealing in securities” definition, and

⁵ As noted in paragraph 214 of the Conclusions Paper, the current proposal is to extend the definition of “market contract” so that it covers OTC derivatives transactions entered into by an RCH in accordance with its rules, but without also requiring that such transactions be novated or traded on any particular platform.

paragraph (iva) of both the “advising on futures contracts” and “advising on securities” definitions. The carve-out aims to avoid fund managers having to obtain a Type 11 RA if they are simply advising on or effecting OTC derivatives transactions for the funds that they are managing. For this purpose, we also propose to expand the Type 9 RA so that it covers portfolios of OTC derivatives transactions as well – see paragraphs 30 to 31 below.

- (7) advisory activities of corporations where advice is given to its **wholly owned subsidiaries, holding company** or other wholly owned subsidiaries of that holding company,

This carve-out is akin to paragraphs (i) of both the “advising on futures contracts” and “advising on securities” definitions.

- (8) advisory activities of **solicitors, counsels, certified public accountants or trust companies** where this is wholly incidental to their practice or duty,

This carve-out is akin to paragraphs (v) to (viii) of both the “advising on futures contracts” and “advising on securities” definitions.

- (9) advisory activities conducted via published or broadcast **media** and made available to the public otherwise than on subscription, and

This carve-out is akin to paragraph (ix) of both the “advising on futures contracts” and “advising on securities” definitions.

- (10) any other activities excluded by subsidiary legislation.

This carve-out is included for flexibility. We consider it would be prudent to include this additional carve-out for flexibility given that the regulation of the OTC derivatives market is a whole new area.

- 13. Apart from the above, we have also considered whether the scope of the new Type 11 RA should expressly exclude the activities of: (i) funds, (ii) persons entering into intra-group transactions or commercial hedging transactions, (iii) providers of post trade services. Our current thinking is that such carve-outs are unnecessary.

- (1) To the extent that a person enters into an intra-group or hedging transaction as a price-taker or end user, the proposed carve-out under paragraph 12(5) above should apply and the person would not need to be licensed. The same goes for transactions entered into by funds. However, to the extent that a person enters into a transaction (including any intra-group or hedging transaction) as a dealer, we believe its activities should be regulated and not excluded from the scope of the new Type 11 RA.
- (2) With respect to providers of post trade services, their dealing activities are likely to come within the definition of ATS (which, as noted in the Consultation Paper, will be expanded as appropriate to cover OTC derivatives transactions as well⁶). As a result, they will be covered by the proposed carve-out under paragraph 12(1) above.

- 14. Lastly, and for completeness, we note that in line with the existing approach under the SFO, employees and officers of an entity that needs to be licensed for the new Type 11

⁶ Currently, the definition of ATS only encompasses facilities for the trading or clearing of securities or futures contracts.

RA will also need to be licensed for such RA if their activities constitute a “regulated function”. Needless to say, this will not apply to employees and officers of an AI or AMB as the activities of such entities will not constitute Type 11 RA and consequently, the activities of their employees and officers will not constitute a “regulated function” in relation to Type 11 RA.

Q1. Do you have any comments or concerns about our proposals for how the initial ambit of the new Type 11 RA should be cast, and the specific activities to be excluded from its scope? If you consider additional carve-outs are needed, please elaborate with justification.

Implications vis-à-vis Type 7 RA

15. A related issue that arises in the context of the new Type 11 RA concerns the provision of ATS.

16. Under the SFO, providers of ATS must either be –

(1) licensed/registered for Type 7 RA, or

*This option – sometimes referred to as a **Part V ATS**⁷ – is essentially for persons who are primarily dealers and wish to provide ATS in connection with their dealing services – e.g. brokers who wish to operate internal crossing engines. The Part V ATS is therefore typically a “bundled” option – i.e. a licence for Type 7 RA is typically bundled with, and granted only to persons who also have (or are seeking), a Type 1 or Type 2 RA.*

(2) authorized under section 95 of the SFO.

*This option – sometimes referred to as a **Part III ATS**⁸ – is for persons that are basically platform providers and that intend to offer their ATS to a wider range of market participants rather than just those for whom they provide dealing services. There is therefore no requirement for such providers to also be licensed/registered for any other RA.*

17. As noted earlier and in the Consultation Paper, the definition of ATS will need to be expanded as appropriate to cover OTC derivatives transactions as well.⁹ Consequently, persons who wish to provide ATS to facilitate trading in or clearing of OTC derivatives will need to either obtain a Part V ATS (i.e. be licensed/registered for Type 7 RA) or a Part III ATS (i.e. be authorized under section 95 of the SFO). Moreover, in the context of a Part V ATS, we expect that the Type 7 RA may¹⁰ need to be bundled with the new Type 11 RA rather than the existing Type 1 or Type 2 RA.

⁷ It is called a Part V ATS because the provisions relating to the application for, and approval of, a licence/registration for Type 7 RA are set out in provisions that come under Part V of the SFO.

⁸ It is called a Part III ATS because section 95 of the SFO comes under Part III of the SFO.

⁹ Currently, the definition of ATS only encompasses facilities for the trading or clearing of securities or futures contracts.

¹⁰ We say “may” here because in some cases the OTC derivatives activities may be covered by the existing RAs (e.g. dealing in OTC equity derivatives on an agency basis may be covered by Type 1 RA), and hence a Type 1 RA would suffice. However, in others cases the activities may not be covered by existing RAs (e.g. dealing in interest rate derivatives), and hence a Type 11 RA will be needed.

18. Because AIs and AMBs will not need to be licensed/registered for the new Type 11 RA, and their OTC derivatives activities will instead be overseen and regulated by the HKMA, the question arises whether they should be allowed to provide ATS for OTC derivatives, and if yes, how their provision of such services should be regulated.
19. Our current thinking in this regard is that so long as –
- (1) the AI or AMB provides ATS to facilitate the trading of OTC derivatives, and
 - (2) the provision of such ATS is incidental to the AI's or AMB's activities of dealing in OTC derivatives,
- then –
- (3) the AI or AMB should be allowed to provide the ATS without obtaining either a Part III or Part V ATS (i.e. without being licensed/registered for Type 7 RA, or authorized under section 95 of the SFO),
 - (4) the AI's or AMB's provision of such ATS should be overseen and regulated by the HKMA, and
 - (5) the SFC and HKMA would then work together to ensure that regulatory requirements applicable to providers of ATS – whether they be AIs, AMBs or LCs – are aligned and consistently applied so as to maintain a level playing field among different market players.
20. The rationale behind this proposal is that since the OTC derivatives dealing activities of AIs and AMBs will be regulated by the HKMA, it makes sense for any incidental ATS activities to be regulated by the HKMA as well. Separating the regulation of the two activities between the two regulators will be inefficient and difficult to manage for both the regulators and the AIs or AMBs. This approach also allows for consistency with the SFC's current approach of requiring the Type 7 RA to be bundled with the relevant dealing RA (i.e. Type 1 or Type 2 RA). However, where an AI's or AMB's provision of ATS is not incidental to its dealing activities, then there appears to be no basis to exempt it from being regulated by the SFC, and in such case the AI or AMB would need to be authorized under section 95, i.e. they would need a Part III ATS.
21. A point to highlight in this context is that if an AI or AMB wishes to provide ATS for trading OTC derivatives, and the provision of such ATS falls within the existing scope of Type 7 RA, it will still need to be licensed or registered for Type 7 RA as it is today. Hence, for example, if an AI or AMB provides ATS for trading OTC equity derivatives, and the provision of such ATS is incidental to its dealing in OTC equity derivatives on an agency basis, the AI or AMB will still need to be licensed/registered for Type 7 RA.
22. For completeness, we also note that if an AI or AMB wishes to provide an ATS platform that facilitates the clearing of OTC derivatives, it will need to be authorized to do so under section 95 of the SFO (i.e. it will need to obtain a Part III ATS). However, in reality, we do not expect AIs or AMBs will want to provide such platforms as a Part III ATS clearing platform provider would essentially be serving as a CCP.
23. We would add here that the operation of a clearing platform is a much more specialised business involving more specific regulatory oversight – e.g. of risk management systems and processes, default arrangements, etc. It also has greater potential for posing systemic risk. Moreover, to the extent that such platforms clear transactions that are subject to the mandatory clearing obligation, they will in any event need to be designated

CCPs and all designated CCPs need to be either an RCH or an authorized provider of ATS under Part III of the SFO. For all these reasons, we consider that AIs and AMBs wishing to offer an ATS platform for clearing OTC derivatives should be required to be authorized under section 95 of the SFO.

Q2. Do you have any comments or concerns about our proposals on how the provision of ATS (for OTC derivatives) by AIs and AMBs should be regulated?

III. Type 12 RA

Initial ambit

24. We propose that the new Type 12 RA should only cover the provision of clearing and settlement services where these are provided –
- (1) in respect of OTC derivatives transactions,
 - (2) through a CCP – whether local or overseas¹¹, and
 - (3) on behalf of another person.
25. It follows therefore that the scope of the new Type 12 RA should not in any event catch the clearing and settlement activities of persons who only clear their own (proprietary) trades. Moreover, where the activities relate to the clearing and settlement of another's trades, the intention is that the initial ambit of the new Type 12 RA should catch the activities of not only persons who are members of a CCP, but also those who intermediate between a CCP member and any counterparty to the transaction in question. It would therefore also include the activities of persons who are indirect clearing members of a CCP and provide clearing in respect of another's trades. Ultimately, the objective is to cover persons that handle client assets in the course of providing clearing and settlement services for OTC derivatives transactions.
26. Additionally, in so far as it captures the activities of a CCP member, we propose that the initial ambit should cover the activities of both –
- (1) persons in Hong Kong who are members of the CCP (and irrespective of whether the CCP is a local CCP or an overseas CCP), and
 - (2) persons overseas (i.e. outside Hong Kong) who are members of a Hong Kong CCP (although, as will be seen in paragraph 28(3) below, we do propose limited exemptions for such persons).
27. For overseas persons who are members of an overseas CCP, we propose that section 115 of the SFO should apply, i.e. if such persons actively market their provision of

¹¹ By a local CCP (or Hong Kong CCP), we mean a CCP that is based in Hong Kong. It includes therefore operations that are essentially established in Hong Kong and irrespective of whether they are authorized as ATS providers or recognized as RCHs. By an overseas CCP, we mean a CCP that is essentially based outside Hong Kong. It includes therefore: (i) CCPs that are primarily regulated by an overseas regulator even though they may be authorized as an ATS provider in Hong Kong, and (ii) CCPs outside Hong Kong that are not regulated under the SFO at all.

clearing agency services to the public in Hong Kong, then they will be regarded as carrying on the new Type 12 RA.

Proposed carve-outs

28. We propose however that the following activities should be excluded from the scope of the new Type 12 RA –

- (1) The activities of a CCP (whether in Hong Kong or overseas, and whether regulated or not) in its capacity as a CCP.

This carve-out is to ensure that the new Type 12 RA does not capture the activities of CCPs which may otherwise fall within the initial ambit discussed in paragraphs 24 to 26 above.

- (2) The clearing agency activities of an AI or an AMB.

This carve-out is to reflect the agreed division of regulatory responsibility between the HKMA and SFC vis-à-vis the OTC derivatives market – see paragraphs 15, 72 to 78, and 237 to 239 of the Conclusions Paper.

- (3) The clearing agency activities of a person that –

- (a) does not have a place of business in Hong Kong,
- (b) is regulated under the laws of an “acceptable overseas jurisdiction” in respect of its provision of clearing agency services,
- (c) provides clearing agency services as a member of a local CCP, and
- (d) either –
 - (i) does not provide clearing agency services to persons in Hong Kong, or
 - (ii) provides clearing agency services to persons in Hong Kong, but any marketing of such services is conducted by a person that is either an AI or an LC.

This carve-out is intended to enable overseas persons to become remote participants of a Hong Kong CCP without having to be licensed for Type 12 RA.¹² The carve-out as proposed would only apply if all of the requirements listed in sub-paragraphs (a) to (d) above are met.

As to what would constitute an acceptable overseas jurisdiction, relevant factors may include: (i) whether the laws of that jurisdiction regulate the provision of clearing agency services in respect of OTC derivatives to a level comparable to that in Hong Kong, and (ii) the adequacy of any regulatory cooperative arrangements or agreements with regulators in that jurisdiction.

Two points are worth highlighting in the context of sub-paragraph (d)(ii) above –

¹² Our reasons for enabling local CCPs to be able to accept overseas clearing members are set out in paragraphs 204 to 208 of the Conclusions Paper.

- First, it is not intended that a remote participant should be compelled to market its services in Hong Kong. In other words, a remote participant may still benefit from the carve-out under sub-paragraph (d)(ii) above even if its clearing agency services are not marketed to Hong Kong persons at all (and hence no AI/LC is involved).
- Secondly, where a remote participant does market its clearing agency services to persons in Hong Kong, we propose that such marketing may be conducted by any AI or an LC licensed for any RA, i.e. it is not necessary that the marketing be conducted by an LC that is itself licensed for Type 12 RA, or by an AI that itself provides clearing agency services for OTC derivatives. The objective is only to ensure that any marketing in Hong Kong is conducted through an entity that is regulated here.

- (4) The clearing agency activities of an agent of a CCP member whose activities as agent do not include handling any client monies or client assets provided in connection with the clearing and settlement of OTC derivatives transactions.

This carve-out is intended to complement the proposed carve-out for remote participants discussed in sub-paragraph (3) above. The remote participant carve-out allows the marketing of clearing agency services to be conducted by an AI or by an LC licensed for any RA. However, if the LC's activities involve more than just marketing, and in particular, if they include the handling of client money or client assets, then the LC will itself need to be licensed for Type 12 RA. In other words, the proposed carve-out for remote participants discussed in sub-paragraph (3) above should not be regarded as allowing an agent of a remote participant to carry on the full range of Type 12 RA without a licence for such RA.

It follows therefore that we propose to require agents of a CCP member to be licensed for Type 12 RA if they do handle client money or client assets. A main reason for this is to ensure that appropriate business conduct requirements can be imposed on such agents, particularly requirements relating to the segregation and portability of client positions and collateral. This would be in line with the recommendations put forward in the IOSCO Report on International Standards for Derivatives Market Intermediary Regulation issued in June 2012. (That report makes recommendations on the business conduct requirements of derivatives market intermediaries, and includes recommendations on the segregation and portability of client positions and collateral.)

29. Lastly, and for completeness, we note that in line with the existing approach under the SFO, employees and officers of an entity that needs to be licensed for the new Type 12 RA will also need to be licensed for such RA if their activities constitute a “regulated function”.¹³ Needless to say, this will not apply to employees and officers of an AI or AMB for the same reasons discussed under paragraph 14 above in the context of Type 11 RA.

Q3. Do you have any comments or concerns about our proposals for how the initial ambit of the new Type 12 RA should be cast, and the specific activities to be excluded from its scope?

IV. Type 9 RA

30. Currently, the scope of Type 9 RA encompasses only the management of portfolios of securities or futures contracts, or of collective schemes where the underlying property is

¹³ Regulated functions refer to functions relating to an RA other than work ordinarily performed by an accountant, clerk or cashier.

mainly realty. As noted in the Conclusions Paper, we propose to expand this so that it also covers the management of portfolios of OTC derivatives transactions.

31. We propose that the expanded Type 9 RA should apply to all persons, including therefore AIs and AMBs. However, this should be subject to the following –
- (1) AIs and AMBs should not have to be registered for the expanded Type 9 RA if their management of portfolios of OTC derivatives transactions is wholly incidental to their carrying on of any dealing activities which, but for the proposed carve-out described in paragraph 12(2) above, would constitute a Type 11 RA. In other words, the expanded Type 9 RA should incorporate a carve-out similar to the one in paragraph (c) of the definition of “securities or futures contracts management” in Schedule 5 to the SFO.
 - (2) A similar proviso should apply to LCs licensed for Type 11 RA such that they should not have to be licensed for the expanded Type 9 RA if their management of portfolios of OTC derivatives transactions is wholly incidental to their carrying on of any dealing in OTC derivatives transactions. In other words, the expanded Type 9 RA should also incorporate a carve-out similar to the one in paragraph (b) of the definition of “securities or futures contracts management” in Schedule 5 to the SFO.

Q4. Do you have any comments or concerns about our proposals for expanding the scope of the existing Type 9 RA?

V. Transitional arrangements for Types 9, 11 and 12 RAs

32. We propose that there should be a limited transitional period (of say four to six weeks) before the two new RAs, and expanded Type 9 RA, are implemented.¹⁴

Type 11 and Type 12 RAs

33. Specifically, we propose that persons who –
- (1) submit applications for any of the new RAs during this transitional period, and
 - (2) confirm in their application that they (and their proposed responsible officers in the case of corporations) have engaged in the relevant OTC derivatives activity (i.e. dealing in/advising on OTC derivatives in the case of Type 11 RA, and providing clearing agency for OTC derivatives in the case of Type 12 RA) in Hong Kong for a specified number of years (and our initial thinking here is to specify about two years) immediately before the coming into effect of the new OTC derivatives regime,

should be deemed to be licensed for the relevant new RA, and such deeming will stay in force until their application is determined. Thereafter, they may continue to engage in such activity if their application is approved, or must immediately cease to do so if their application is rejected.

¹⁴ Hence if the new RAs (or expanded Type 9 RA) are implemented from 1 July 2012, then the four to six week transitional period should expire immediately before 1 July 2012.

34. We believe the above proposal strikes a practical balance between minimising disruption to market players, and ensuring that the deeming option is not abused by persons with no relevant experience in Hong Kong. The requirement to provide confirmation in this regard is significant as provision of false information in applications to the SFC can constitute an offence under section 383 of the SFO.
35. We also propose that transfers of accreditation should be possible during the transitional period but only if the person seeking the transfer, and the corporation to which he/she wishes to be accredited, are already licensed or deemed to be licensed.
36. For applicants who submit their licensing applications after the transitional period, we propose that no deemed status should be conferred, and hence they will not be able to conduct Type 11 or Type 12 RA until their licensing application is approved.

Expanded Type 9 RA

37. We propose similar transitional arrangements for the expanded Type 9 RA as well, save that applicants for the expanded Type 9 RA should –
- (1) already be licensed (or registered in the case of AIs) for Type 9 RA, and
 - (2) confirm in their application that they, or their proposed responsible officers, have engaged in managing portfolios of OTC derivatives transactions in Hong Kong for a specified number of years (and our initial thinking here is to specify about two years) immediately before the coming into effect of the new OTC derivatives regime.
38. A point to note in respect of the expanded Type 9 RA is that the applicant would not be applying for a new licence or registration for Type 9 RA, but only for the conditions on his existing licence/registration for Type 9 RA to be modified so that they permit the management of OTC derivatives portfolios.

Q5. Do you have any comments or concerns about our proposed transitional arrangements for the new Type 11 and Type 12 RAs, and for the expanded Type 9 RA?
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VI. Other amendments

39. Apart from amending Schedule 5 of the SFO to reflect the new RAs and expanded Type 9 RA, we propose to introduce consequential amendments to the following provisions of the SFO as well –
- (1) Section 109 – This section prohibits the issuing advertisements that hold out a person as carrying on Type 4, 5, 6 or 9 RA when the person is not licensed or registered for that RA. For consistency, we propose to extend this provision so that it applies in respect of the new Type 11 RA as well.
 - (2) Section 119 – This section empowers the SFC to register AIs to carry on RAs other than Type 3 or Type 8 RA. (Type 3 and Type 8 RAs are excluded because AIs are not required to be registered to carry on these RAs, and hence there is no need to empower the SFC to register AIs for such RAs.) As AIs will not have to be registered for the new Type 11 or Type 12 RA either, we propose to extend the exclusion in section 119 so that it covers Type 11 and Type 12 RAs as well.

- (3) Section 181 – This section empowers the SFC to obtain information relating to securities, futures contracts, leveraged foreign exchange contracts and collective investment schemes. We propose to extend the section so that the SFC can also obtain information relating to OTC derivatives transactions. This will necessitate amendments to subsections 181(1)(b), (c) and (d), as well as subsections 181(2)(a), (b) and (c).
- (4) Section 182 – This section essentially sets out the triggers for the SFC's investigation powers. As indicated in paragraph 33 of the Conclusions Paper, a new triggering event will be added to empower the SFC to investigate where it has reasonable cause to believe that any of the mandatory obligations may have been breached by a non-AI. Additionally, in view of our proposal to introduce two new RAs and expand Type 9 RA, we also propose to extend subsection 182(1)(b) so that the SFC can investigate where it has reasonable cause to believe that a person may have engaged in defalcation, fraud, misfeasance or other misconduct in connection with any dealing in, clearing of, or advising on an OTC derivatives transaction, or the management of investments in any OTC derivatives transactions.
- (5) Section 186 – This section empowers the SFC to assist overseas regulators in connection with breaches relating to securities, futures contracts, leveraged foreign exchange contracts, collective investment schemes or other similar transactions. We propose to extend this so that it covers assistance in relation to OTC derivatives transactions as well.

VII. Regulation of SIPs

- 40. The Conclusions Paper confirmed the need for the HKMA and SFC to have a degree of regulatory oversight of SIPs and their activities. In the following paragraphs, we set out our specific proposals in this regard.

Criteria for determining who is an SIP

- 41. In the Consultation Paper, we proposed to use both quantitative and qualitative criteria to determine whether a person should be regarded as an SIP or not. On reflection however, we believe we should only use quantitative criteria as that provides greater certainty and clarity for market participants. Reliance on qualitative criteria introduces an element of subjectivity which makes compliance difficult.
- 42. As to what the quantitative criteria should be, we are still considering this. Essentially, the idea is that Hong Kong persons whose OTC derivatives positions exceed a certain specified level (**SIP threshold**) will be regarded as SIPs. The SIP threshold may be set by reference to a person's aggregate holdings in all OTC derivatives transactions, or to holdings in a particular product class or transaction type, or a combination of the foregoing. However, it should in any event be many times higher than the reporting and clearing thresholds as the intention is to capture market participants in the OTC derivatives market who are not regulated and whose positions are not just large but so large as to have the potential to threaten the financial market stability of Hong Kong. It follows therefore that the objective is to capture only those end-users whose possible failure (as a result of their activities in the OTC derivatives market) could have significant implications for Hong Kong as a whole. Consequently, we expect that the SIP threshold should be such that only a handful of market players, if any, may be caught.

Registration and deregistration of SIPs

43. The Consultation Paper also noted that we were not convinced SIPs should be regulated as licensed persons since they are not carrying on any intermediary function. We remain of this view, but also feel some form of registration with the SFC is necessary if the OTC derivatives positions and activities of SIPs are to be monitored effectively. However, any registration process should be relatively mechanical and without involving any application or approval process. Accordingly, we propose as follows –
- (1) Anyone who exceeds the SIP threshold should notify the SFC of such fact within a specified period, and failure to do so should constitute an offence. We are still considering what the specified period and penalties for such offence should be. One possibility is for the period and penalties to be on a par with those for other notification obligations under Part XV of the SFO.¹⁵
 - (2) The SFC should then enter the names of such persons, and details of their OTC derivatives positions, in a register of SIPs. The register of SIPs should be kept and maintained by the SFC but information in it should be available to both the HKMA and the SFC as both regulators have a role in overseeing and regulating the OTC derivatives market.
 - (3) We are still considering whether the names of SIPs entered in the register should be disclosed to the public.
44. We also propose that the HKMA and SFC should be able to enter the name of a person in the register of SIPs at their own initiative, subject however to having first given the person a short period to object or clarify why their name should not be so entered. This would be useful where the HKMA or SFC have reason to believe that a person has exceeded the SIP threshold but has not notified the SFC of such fact. Additionally, we propose that the name and details of a person may be removed from the register of SIPs if his positions have not exceeded the SIP threshold for a continuous period of one year. We also propose that such removal may be initiated by the person in question or by the HKMA or SFC.

Regulatory powers in respect of persons registered as SIPs

45. In order that the HKMA and SFC can effectively monitor the OTC derivatives market and take action to stem potential systemic risk, we propose that they should have certain regulatory powers in respect of persons whose names are entered in the register of SIPs. In particular, the HKMA and SFC should be able to –
- (1) require any such person to provide information regarding its activities and transactions in the OTC derivatives market as may be specified, and
 - (2) if the HKMA or SFC has reasonable cause to believe that OTC derivatives activities or transactions of any such person may pose systemic risk in the securities, futures or OTC derivatives markets in Hong Kong, require such person to take any of the following action –

¹⁵ Notifications under Part XV must generally be made within three business days, and breaches are subject to fines at level 6 (HK\$100,000) and imprisonment for 2 years (on indictment), and to fines at level 3 (HK\$10,000) and imprisonment for 6 months (on summary conviction).

- (a) refrain from increasing its positions in any OTC derivatives transactions,
- (b) reduce its positions in any OTC derivatives transactions,
- (c) take such action in respect of any related collateral as specified (e.g. collect or post collateral, increase the amount of collateral collected or posted, restrict the use of collateral posted, etc), and
- (d) take such other action as may be reasonably required.

46. We further propose that the above powers should be exercised by the SFC, but only with the HKMA's consent or at its recommendation. This would be in line with the proposal that the OTC derivatives market should be jointly overseen by the HKMA and SFC.
47. Additionally, we are also considering whether the powers described in paragraph 45(1) above should be extended so as to enable regulators to obtain information about the OTC derivatives positions and activities of persons related to the SIP, such as companies within the same group as the SIP. We would welcome feedback on this issue.

Disciplinary powers and rights of appeal

48. To ensure that a person complies with any requirement to produce information or take action as described in paragraph 45 above, we propose that the SFC should have power to take disciplinary action for breach of such requirement, and to apply to the court to compel compliance if necessary.
49. To that end, we propose to extend the disciplinary provisions under Part IX of the SFO so that the SFC may (with the consent of the HKMA, or at its recommendation) take disciplinary action against persons who fail to comply with such requirements. However, the range of sanctions would be limited to public/private reprimand and disciplinary fines of up to HK\$10 million. Additionally, disciplinary action would only be taken against the person registered in the register of SIPs, and not against any director or member of its management.
50. Additionally, given the potentially significant role that SIPs may have on the market, we are also considering whether the proposed disciplinary powers discussed above should also be exercisable in respect of breaches of any of the mandatory obligations.¹⁶
51. We also propose to introduce a provision similar to section 185 of the SFO so that the SFC may (with the consent of the HKMA, or at its recommendation) apply to the court in respect of a person's failure to comply with such requirements. Here again, we propose that this should only allow the court to make an order against the person registered in the register of SIPs, and not any other person.
52. Lastly, we propose to introduce rights of appeal against –
- (1) any decision to enter a person's name in the register of SIPs (as described in paragraph 44 above), and

¹⁶ Thus far, we have only proposed that regulators be able to take disciplinary action for breach of the mandatory obligations if the breach is by an AI, LC or AMB. For breaches by other persons (including therefore persons whose names are entered in the register of SIPs), we have thus far only proposed a civil penalty – see paragraph 189 of the Conclusions Paper.

- (2) any requirement to provide information or take action as specified (as described in paragraph 45 above).

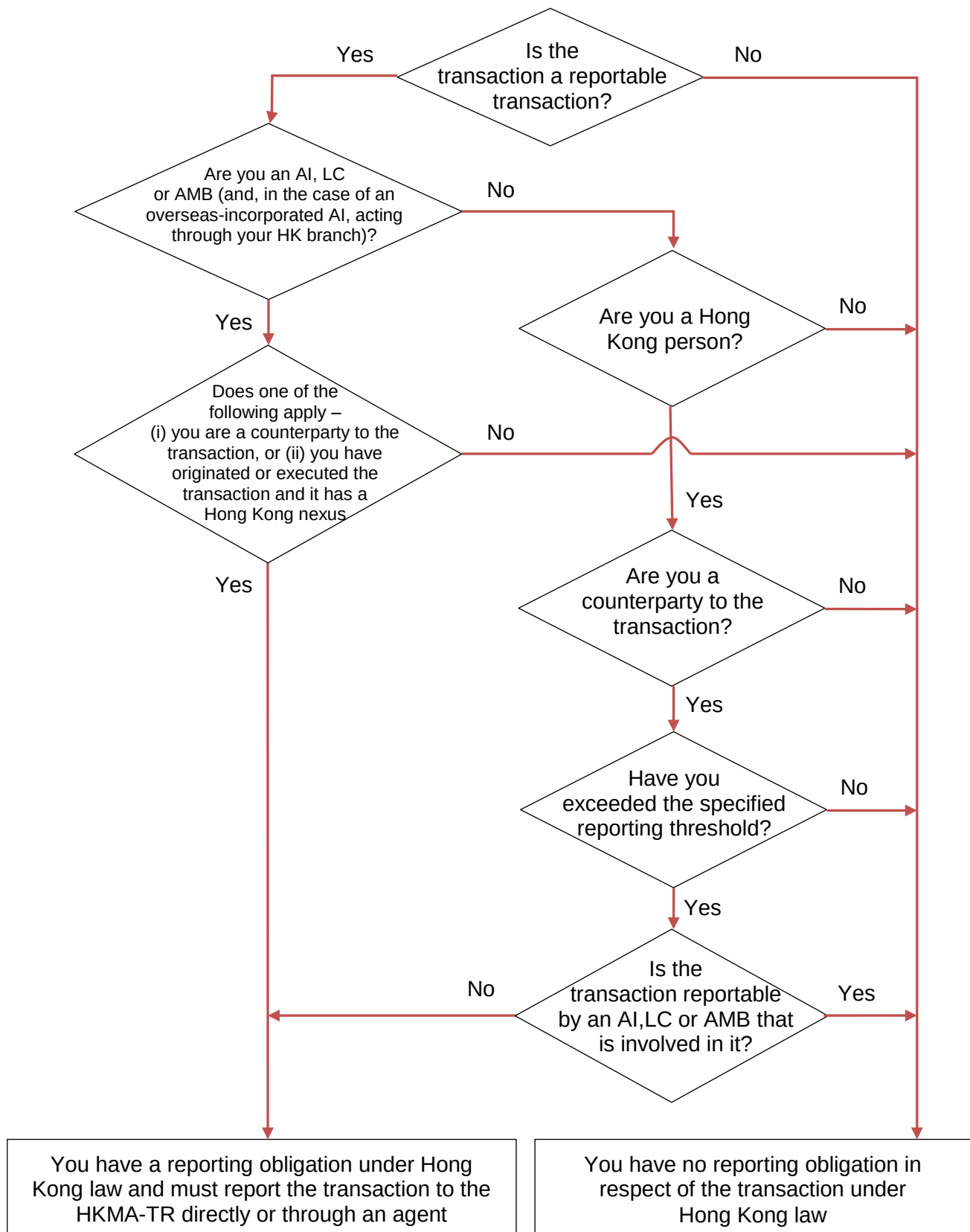
53. Such appeals would be heard before the Securities and Futures Appeals Tribunal.

Q6. *Do you have any comments or concerns about our proposals for how SIPs should be identified and regulated?*

VIII. Views sought

54. We invite views on any aspect of the proposals in this supplemental consultation. The feedback received will help finalise our views on how the new RAs should be cast, how the expanded Type 9 RA should be cast, and how SIPs should be regulated.

Appendix 3 – Flow chart for the proposed mandatory reporting obligation



Appendix 4 – Flow chart for the proposed mandatory clearing obligation

